NATP

# TAXPRO

December 2024
Issue 12
Volume 46

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Tax Implications

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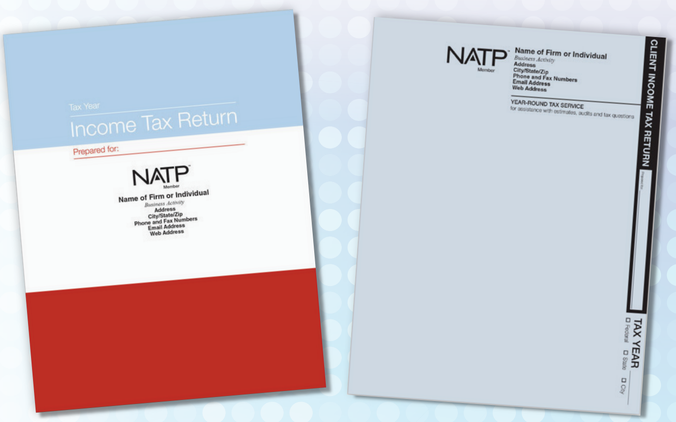


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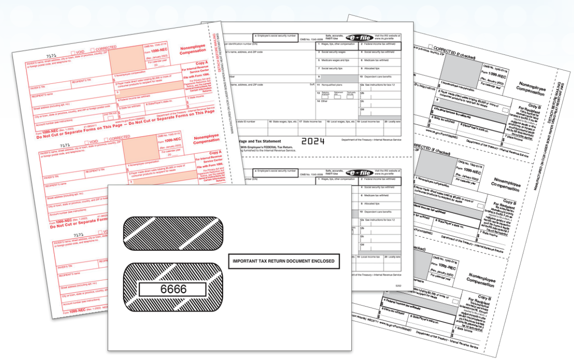

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# Excellence in Focus

## Stay Plugged into the Power of Connection

### Perspectives from NATP Board Secretary Jackie Sanders, AFSP

The NATP organization is like a charging station. If you connect by plugging in, you will receive the power to accomplish your next level of personal growth, the next level of friendships and the next level of professional growth.

Recently, a woman asked to sit at the table with me and smoke, and my reply was no thanks. She quickly let me know she wasn't asking me. Because I wasn't open to her smoking, she turned her chair with her back to me and let her smoke come directly at me. I waited. She smiled and said, "You nonsmokers, you always have your nose in the air." "Smokers are good people," she explained. "They can connect easily with others while smoking together."

I realized my preference had caused me to miss a meaningful conversation and an opportunity to connect. I soon realized that I had times I'd miss out on connecting because of my preconceived notions. The next day, the same woman sat down at the table with me. This time, she doesn't ask; she just sits and starts talking. For over an hour, we have the most amazing conversation and in that moment, the wealth of knowledge she had accumulated came pouring out with such an impact that I would have missed out on had I not been willing to change my perspective.

On that same trip from the balcony one morning, I observed a roofer extending his electrical cord to an available power source. The cord extended from the rooftop across the lawn to a boat's charging station nearby. From a distance, you could not tell where the power source was, but the sound of drilling and power tools operating told me that there was a connection to power. I began to think of family members, friends, organizations and colleagues that are the unseen power sources that give me vital insight into how to keep moving forward.

If you are like me, being useful brings joy. This season ahead may bring change to how we can be more efficient, productive and successful. Remember there is always a place where human connections will be needed and valued. People are always the most valuable asset on our personal balance sheet. Who we are becoming is of great value and importance.

I encourage you to stay plugged into the power source of NATP for your professional growth. When we embrace growth and development, we find ourselves in the company of those who elevate our perspectives. With proper perspective, we can simplify systems, overcome challenges, and understand our business purpose by making better decisions and bringing the impossible within reach.

In the season ahead we must master leading at every level. If it's expansion or selling, make sure you finish strong. I look forward to making connections that bring growth. ▶

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  Dec. 18: 10:00 a.m. - 11:00 a.m.
- **Navigating the Rules and Responsibilities of the New Form 7217**
  Dec. 18: 2:00 p.m. - 4:00 p.m.
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- **Annual Tax Update (Spanish)**
  Jan. 7: 10:00 a.m. - 1:00 p.m.

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  Dec. 13: 10:00 a.m. - 2:00 p.m.

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## About us

The National Association of Tax Professionals (NATP) is the largest association dedicated to providing tax professionals with the resources, connections and education they need to skillfully deliver federal tax preparation services to their clients. NATP is comprised of over 23,000 leading tax professionals who have a superior standard of ethics and professional excellence. Serving nearly 11 million taxpayers, members rely on NATP to deliver connections, content expertise and advocacy. NATP welcomes all tax professionals in their quest to continually meet the public's needs, no matter where they are in their careers. NATP is headquartered in Appleton, WI. To learn more, visit natptax.com.

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# TAX UPDATE

## Consistent Basis Guidance for Estates and Beneficiaries

**By Christine Novak, CPA**
**NATP Tax Content Specialist**

The IRS recently issued final regulations regarding the consistent basis requirement under §1014(f) for certain property acquired from a decedent along with the applicable information reporting requirements under §6035 for certain executors. The final regulations generally adopted the 2016 proposed regulations with some revisions.

For example, the final regulations:

- Remove the zero-basis rule for property not reported on the estate tax return
- Adopt a suggested interpretation of the term 'acquiring' under §6035(a)(1), which modifies the reporting requirements if the beneficiary does not acquire property before the estate tax return due date
- Eliminate the subsequent transfer reporting requirement for all beneficiaries other than trustees
- Except additional types of property interests from the consistent basis and §6035 reporting requirements

In general, under §1014(f)(1), the initial basis of certain property acquired from a decedent cannot exceed the final value determined for federal estate tax purposes on Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, or, if the final value has not been determined, the value reported on Form 8971, *Information Regarding Beneficiaries Acquiring Property From a Decedent*. This general rule is referred to as the consistent basis requirement. However, an exception to this rule is provided under §1014(f)(2), which states the consistent basis requirement only applies to property whose inclusion in the decedent's gross estate increased the federal estate tax liability. Reg. §1.1014-10 provides more guidance, definitions and examples of this consistent basis requirement.

First, the consistent basis requirement only applies to *included property*, which generally means property whose value is included in the gross estate and reported on Form 706 [Reg. §§1.1014-10(c)(1)(i) and(d)(4)]. Under the 2016 proposed regulations, if includible property was not reported on Form 706, the final value of such property was zero. However, the final regulations did not adopt this zero-basis rule. Instead, the basis of includible property acquired from a decedent but not reported on Form 706 is determined as usual under §1014(a). In other words, the beneficiary's basis equals the FMV of the property on the decedent's date of death or alternate valuation date (if elected), even though it was not reported on Form 706.

Second, the consistent basis requirement only applies to included property that increased the decedent's federal estate tax liability. For example, if included property qualifies for the estate tax or the charitable or marital deduction, such property does not generate a tax liability. Since this property does not increase the estate tax, it is excluded from the consistent basis requirement. However, the final regulations clarify this property must be wholly deductible to be excluded [Reg. §1.1014-10(c)(2)(xi)]. If such property only qualifies for a partial marital or charitable deduction, it is subject to the consistent basis requirement.

The final regulations also confirm that a surviving spouse's interest in community property to which §1014(b)(6) applies is not subject to the consistent basis requirement because it is not includible in the decedent's gross estate [Reg. §1.1014-10(c)(2)(xii)]. For more exclusions, Reg. §1.1014-10(c)(2) provides a list of property that is not subject to the consistent basis requirement. The final regulations apply to consistent basis property acquired from a decedent if the decedent's Form 706 is filed after Sept. 17, 2024.

The final regulations also provide more guidance on the executor's reporting requirements under §6035. Beneficiaries need this information to comply with the consistent basis requirement. In general, if Form 706 is required to be filed under §6018(a), the executor must furnish basis information for certain property reported on Form 706 to each person acquiring such property from the decedent [§6035(a)]. In this case, the executor must file Form 8971, including Schedule(s) A – *Information Regarding Beneficiaries Acquiring Property From a Decedent*, and furnish each beneficiary listed on that form with their respective Schedule A. On the other hand, Reg. §1.6035-1(b)(1) clarifies these reporting requirements do not apply if Form 706 is not required to be filed, even if the executor files Form 706 for other purposes (for example, to make a portability election under §2010(c)(5) to transfer the deceased spousal unused exclusion (DSUE) amount to the surviving spouse).

In general, the executor must file Form 8971 and furnish Schedule A to each beneficiary within 30 days after the Form 706 due date (including extensions), or within 30 days after the date Form 706 was filed, if earlier [§6035(a)(3)]. However, if the beneficiary acquired property subject to reporting after the Form 706 due date (or earlier filing of Form 8971), Reg. §1.6035-1(c)(3)(ii) clarifies Schedule A must be furnished to the beneficiary by Jan. 31 of the calendar year following the year of acquisition. In addition, the executor must file a supplemental Form 8971 with an attached copy of that Schedule A by the same Jan. 31 due date. Executors also have the option to furnish Schedule A before the beneficiary acquires property, but only if they have reason to know the beneficiary will in fact acquire the property [Reg. §1.6035-1(c)(5)]. Reg. §1.6035-1 provides more guidance and examples regarding these reporting requirements. The final regulations apply to executors who are required to file Form 706 under §6018 if that return is filed after Sept. 17, 2024.

It is important executors understand these rules and requirements to avoid unnecessary penalties for failure to file correct information returns under §6721 or failure to furnish correct payee statements under §6722. In addition, a beneficiary could be subject to a 20% accuracy-related penalty under §6662(b)(8) for an underpayment of tax required to be shown on their income tax return that is attributable to an inconsistent estate basis [Reg. §1.6662-9].

For more information regarding the consistent basis requirement, §6035 reporting requirements and potential penalties, see TD 9991 (https://public-inspection.federalregister.gov/2024-20429.pdf). ▸

# This & That

## The Secrets of Visionary Thinkers: 10 Rules for Brainstorming Success

By Susan Robertson

At various times, the popular press raises the idea that group brainstorming isn't effective at generating creative solutions. That assertion is erroneous, for a variety of reasons. Groups can – and do – successfully brainstorm creative and useful solutions.

But research does show that effective brainstorming requires adherence to some specific guidelines. If it's done casually, without guidelines, and the sessions are run by people with no knowledge of how to do it well, it will be significantly less effective than it could be.

It will either result in unrestrained chaos with no momentum to move the project forward, or it will just be plain boring (which also results in no momentum).

(And for those of you who know that brainstorming is only one technique in a creative thinking toolbox, please excuse the shortcut. Most people think of brainstorming as any idea generation, and that's the way it's used here.)

So, how do you set up your brainstorming sessions for success? Follow the rules. They will see you safely through the necessary level of chaos, to the strategic momentum you're hoping for.

1. **Free them from the fear.** It's very difficult for people to share ideas if they're concerned about possible negative consequences. A process and a setting that help people get past the fear are critical for the brainstorming to be effective. One key principle in creating this setting is to prohibit any evaluation (even positive evaluation) during the idea generation.
2. **Use the power of the group.** Build, combine and create new ideas in the moment. Don't just collect ideas that people have already had. ***The building and combining is where the magic happens.*** Occasionally break up into pairs or small groups. This will encourage even more sharing and combining of ideas.
3. **Get some outside stimulus.** Duh. Asking the same group of people to sit in the same room and review the same information they've seen before is unlikely to result in exciting, new ideas. Talk to your customers, talk to other experts, explore how other industries are doing it. Have the meeting in the park or in a museum. Bring some toys into the room. There are countless ways to shake things up; try something new every time.

4. **Encourage the crazy.** Everyone has heard someone say at the beginning of a brainstorming, "every idea is a good idea." And then there's a collective eye roll because no one believes it. While it's not true that every idea is a practical idea, ***it is true that every idea can offer useful stimulus for additional ideas***. Sometimes those ideas that are tossed out as jokes can be the spark that leads to a new direction and a winning idea. So allow, encourage and use every idea, even if only for creative fodder.
5. **It's a numbers game.** The more "at bats" you have, the more likely you are to hit a home run. So drive for quantity of ideas. Ensure the session is long enough to generate lots. If you only spend 10 minutes on brainstorming, don't expect great results.
6. **Laugh a lot.** Humor stimulates creativity, so let it happen. One easy way to start off a session; have everyone introduce themselves by answering a fun or silly question. One example you could use in the fall: "what's something you DON'T need more of for the holidays?" Some of the answers could even start sparking real ideas for the session!
7. **Homework is required.** Both individual and group efforts are critical for success. So expect and insist on individual preparation in advance and follow-up afterward. Ensure everyone knows the goal in advance of the session and ask them to do some homework before they arrive. When the session is over, create an action plan that allows ideas to continue to be shaped and added to as you move forward.
8. **It's not for amateurs.** Effective brainstorming requires knowledge and skill, both to participate, and especially to facilitate. It's a completely different set of techniques and expertise than running other meetings, so don't assume you can do it well just because you can run a great meeting. If you don't have a facilitator in your team who has the skill to train the group and run the session, hire an external one or get some training to develop the skills internally.
9. **If it looks like a duck, but doesn't act like a duck, it's not a duck.** If you can't, or don't intend to, follow the guidelines for successful brainstorming, then don't call it brainstorming. For example, a meeting that just becomes a stage for one person to spout their ideas isn't useful or engaging. And if a brainstorming session is not organized and structured appropriately, everyone in the room will feel how ineffective it is, and they'll be sure to skip your next session. So, either set up for success or don't bother.
10. **You're not done until you decide.** You've all been in this situation; it's the end of a brainstorming session, you've created a long list of ideas, and someone volunteers to type up and distribute the list. And… that's the end. There's no action, or at least not that anyone is aware of. It's fairly demotivating to spend time and energy generating ideas and then feel they went nowhere. So, plan time for, and require the group to do, some prioritizing of ideas during the session. Spend at least an equal amount of time on converging as you do on diverging. Yes, you read that right. ***If you generate ideas for an hour, also spend an hour on selecting, clarifying and refining ideas at the back end.*** If you leave the meeting with a huge list of potential ideas, that's not success. You want to leave the meeting with a short list of clear ideas, and a plan for action on each of them. ▶


### About the Author

Susan Robertson empowers individuals, teams, and organizations to more nimbly adapt to change, by transforming thinking from "why we can't" to "how might we?" She is a creative thinking expert with over 20 years of experience speaking and coaching in Fortune 500 companies. As an instructor on applied creativity at Harvard, Susan brings a scientific foundation to enhancing human creativity. To learn more, please go to: SusanRobertsonSpeaker.com.


**Earn 1 CPE**

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# Entity Conversion

## Tax Implications

By Jan Socha, CPA
NATP Tax Content Specialist

The day may come when a client approaches you about switching their business entity structure to one that aligns more with the evolving needs of their business. You may also suggest to the client that they change their entity structure. As a trusted business advisor, you are in a unique position to make recommendations as you understand the business owner's current and future business needs and can assist with navigating the tax implications that accompany a change in entity structure. Two common changes that business owners may consider making are switching their business entity from a C corporation to an S corporation, and from a C corporation to a limited liability company (LLC) taxed as a sole proprietorship.

Each of these changes comes with a set of benefits and tax implications. It is crucial that you conduct a comprehensive analysis of the potential tax implications of a change in entity structure and educate the client on the ramifications. One structure is not necessarily better than another. The needs of each business should be assessed, and the advantages and disadvantages of each structure must be considered.

### Switching from a C corporation to an S corporation

Corporations are a legal entity established by a charter (also called articles of incorporation or a corporate charter) from the Secretary of State in the state in which the corporation is being organized. A for profit corporation will always file a Form 1120 series form. Domestic corporations will generally file Form 1120, *U.S. Corporation Income Tax Return*, and Form 1120-S, *U.S. Income Tax Return for an S Corporation*, is filed by a corporation or other entity if it elects to be an S corporation by filing Form 2553, *Election by a Small Business Corporation*, the IRS accepted the election, and the election remains in effect. Form 1120-S is not filed for any tax year before the year the election takes effect. If requirements are met, a domestic small business corporation can elect to be an S corporation. Some entities may be eligible for relief for a late-filed election to be an S corporation.

#### Why switch?

Potential tax savings may be a primary reason companies might consider electing S corporation status. The issue of double taxation may be a concern for some businesses structured as a C corporation and this concern may be eliminated if they are taxed as an S corporation. C corporations pay a flat 21% tax on their taxable income. From that taxed income, the C corporation may distribute the profits as dividends to shareholders. When the C corporation pays dividends to its shareholders, each shareholder will include the dividend in income and pay tax. This results in double taxation. The corporation does not receive a tax deduction for the dividends they pay to shareholders. When a shareholder-employee is performing most of the work, the risk of double taxation may be reduced because the C corporation can deduct reasonable compensation paid to the shareholder-employee. This results in little income available for distributions as dividends. If a C corporation has minimal taxable income after compensating the shareholder-employee and paying fringe benefits, the effect of double taxation may be minimal. If, however, the company is growing and taxes are paid on the profits, and taxable dividends are paid to shareholders, the impact of double taxation may be of concern. Generally, C corporations can deduct fringe benefits paid to the shareholder-employee without the shareholder-employee including them in income and paying tax. In an S corporation, special rules apply to fringe benefits paid on behalf of a 2% shareholder.

## Factors to consider

### Dividend tax rates

The maximum tax rate on qualified dividends is 20%. In 2024, the dividend rates are 0%,15%, or 20% on qualified dividends, depending on the taxpayer's taxable income. For qualified dividends to qualify for long-term capital gains rates, shareholders must satisfy holding period requirements. If a dividend does not qualify as qualified dividends, it will be classified as an ordinary dividend, taxable as ordinary income, at rates as high as 37%.

Qualified dividends are distributions of cash or property made by a domestic corporation out of its earnings and profits (E&P) to a shareholder with respect to its stock [§1(h)(11)(B)(i) and §316]. Generally, distributions from a domestic C corporation to the extent of E&P are qualified dividends. An S corporation can only have E&P if it was formerly a C corporation.

**Note:** Distributions from a S corporation often will not be qualified dividends because they are not made from E&P but are a distribution of S corporation earnings. The treatment of an S corporation distribution will depend on the shareholder's basis in their S corporation stock and the S corporation's E&P and accumulated adjustments account (AAA).

### NIIT

A 3.8% net investment income tax (NIIT) applies to most dividends. The NIIT applies to taxpayers with modified adjusted gross income (MAGI) that exceeds $250,000 for joint return and surviving spouses or $200,000 for single taxpayers and heads of households. Because of the NIIT, the overall tax rate on qualified dividends for some higher-income taxpayers will be 18.8% (3.8% NIIT + 15% capital gains rate) or 23.8% (3.8% NIIT + 20% capital gains rate).

Dividends paid by a C corporation are generally taxed as net investment income (NII). IRS Chief Counsel Advice 202118009 (Jan. 04, 2021), states that dividends paid to an individual shareholder of a C corporation is NII, even if the shareholder is an employee who is involved in the company's business and the C corporation is closely held. What this means is that dividends paid by a C corporation will generally not qualify for the trade or business exception. While the Chief Counsel Advice cannot be used or cited as precedent, it provides an idea on the IRS's position regarding NIIT to C corporation dividends. On the other hand, income from a trade or business conducted by an S corporation is not NII to a shareholder who actively participates in the trade or business [Reg. §1.1411-4(b)(2)].

### Individual tax bracket

Keep in mind, there may be situations where the shareholder is in a tax bracket higher than 21% and switching to an S corporation may be a negative. Since 2018 (tax years beginning after 2017), the corporate tax rate is 21%, which is below the top rate of 37% for individual taxpayers. For tax years 2018-2025, an individual's taxable income is subject to seven tax brackets. These brackets are 10%, 12%, 22%, 24%, 32%, 35% and 37%. If a corporation plans to keep profits inside the entity, a C corporation may be more advantageous. Also, Congress may reassess the corporate tax rates in 2025, calling for a raise to possibly 28% (half-way between the current rate (21%) and the pre-2018 highest rate (35%)) which would raise needed revenue [https://www.cbpp.org/research/federal-tax/congress-should-revisit-2017-tax-laws-trillion-dollar-corporate-rate-cut-in].

## QBI

The §199A 20% qualified business income deduction (QBID), which is available to qualifying noncorporate individuals, helps but does not eliminate the difference between corporate and individual rates. The QBID is a tax provision that allows eligible business owners to deduct up to 20% of their qualified business income (QBI) from their adjusted gross income (AGI). For tax years beginning after Dec. 31, 2025, the provisions under §199A will expire unless they are extended by Congress. The QBID is available to shareholders of an S corporation; however, it is not available to shareholders of a C corporation, including members of a limited liability company (LLC) taxed as C corporations. The QBID is one factor that should be considered when determining if a change in entity classification should be made.

**Example – S corporation more advantageous**

Let us compare the tax effects of being a C corporation versus an S corporation, with a corporation with $250,000 in income. For illustration purposes, we are assuming no other individual income (see table below).

In this scenario, the S corporation structure provides for a higher net income after taxes by $19,866 ($196,985 - $177,119). This is primarily due to avoiding the double taxation which occurs in the C corporation structure. The QBID would not be a factor in this example, as it will be phased out.

As the next example illustrates, the corporation can retain earnings instead of distributing them as dividends and in this is the case the C corporation could be the more advantageous entity.

**Example – C corporation more advantageous**

In this scenario, the corporation has a profit of $250,000, but only distributes $50,000 as dividends. The remaining money is left in the corporation (see second table).

In this scenario, the C corporation structure provides for a little higher net income after taxes by $515 ($197,500 - $196,985). This is primarily due to avoiding double taxation by taking advantage of the zero-tax on the dividend income.

While the examples are simplistic, they do illustrate that determining the desirable business entity depends on many factors and assumptions.

| Category | C Corporation | S Corporation |
|---|---|---|
| Corporate income | $250,000 | $250,000 |
| Corporate tax rate | 21% | N/A |
| Corporate tax paid | $52,500 ($250,000 x .21) | N/A |
| Net income after corporate tax | $197,500 ($250,000 - $52,500) | $250,000 |
| Dividend distribution | $197,500 | N/A |
| Standard deduction (individual) | $14,600 | $14,600 |
| Taxable income (individual) | $182,900 ($197,500 - $14,600) | $235,400 ($250,000 - $14,600) |
| Dividend tax rate (individual) | 0%-15% ($47,025 is taxed at 0%; the balance at 15%) | N/A |
| Dividend tax paid (individual) | $20,381 (($182,900 - $47,025) x.15) | N/A |
| Total taxes paid | $72,881 ($52,500 + $20,381) | $53,015 (10%-35% bracket) |
| Net income after all taxes | $177,119 ($250,00 - $72,881) | $196,985 ($250,000 - $53,015) |

| Category | C Corporation | S Corporation |
|---|---|---|
| Corporate income | $250,000 | $250,000 |
| Corporate tax rate | 21% | N/A |
| Corporate tax paid | $52,500 ($250,000 x .21) | N/A |
| Net income after corporate tax | $197,500 ($250,000 - $52,500) | $250,000 |
| Dividend distribution | $50,000 | N/A |
| Standard deduction (individual) | $14,600 | $14,600 |
| Taxable income (individual) | $35,400 ($50,000 - $14,600) | $235,400 ($250,000 - $14,600) |
| Dividend tax rate (individual) | 0% (applies to taxable income up to $47,025) | N/A |
| Dividend tax paid (individual) | $0 | N/A |
| Total taxes paid | $52,500 ($52,500 + $0) | $53,015 (10%-35% bracket) |
| Net income after all taxes | $197,500 ($250,00 - $52,500) | $196,985 ($250,000 - $53,015) |

| Requirements for a Corporation to be an S Corporation | |
|---|---|
| • Must be a domestic corporation | • Must not be an ineligible corporation |
| • Must not have more than 100 shareholders | • Individuals, decedents' estates, estates of individuals in bankruptcy, certain trusts and certain tax-exempt organizations are shareholders |
| • No nonresident alien shareholder | • Only one class of stock; however, different voting rights are allowed |

## Eligibility to be an S corporation

Some closely held C corporations can elect to be taxed under Subchapter S [§§1361-1379] instead of under the regular rules for taxation of corporations, which are governed by Subchapter C [§§301-385].

If the S election is made, the corporation's income (with some exceptions) is "passed through" and taxed to its shareholders instead of being taxed at the corporate level. The double taxation of the corporation's income is thus eliminated. S corporations are treated as pass-through entities, and items of income, loss, deduction, and credit pass through to the shareholders and are included on the shareholders' tax return and taxed at the individual rate.

In situations where the C corporation is losing money, the losses are stuck at the corporate level and are not deductible by the shareholders. If an S corporation shareholder is allocated an item of S corporation loss, the shareholder may be able to claim the loss on their individual return. Losses are not limited at the S corporation level; they pass through to the shareholder(s) in full and are subject to limitations, if any, at the shareholder level. To be able to deduct a loss, the S corporation shareholder must pass four loss limitations. The limitations are stock and debt basis; at risk; passive activity loss; and excess business loss (for tax years beginning after 2020 and before 2029).

C corporations are eligible to change to an S corporation if certain requirements are met. These are shown in the table above.

### Domestic corporation

A domestic corporation is a corporation that is created or organized in the U.S. or under federal or state law [§7701(a)(4)]. Also, the term corporation includes an entity that is classified as an association taxable as a corporation [Reg. §301.7701-2(b)].

**Note:** In IRS Private Letter Ruling (PLR) 200226032, a general partnership and a limited liability partnership (LLP) that were formed under state law and had elected to be treated as an association taxed as a corporation was eligible to elect S corporation status and its partnership agreement would not create a second class of stock. See IRS Private Letter Ruling (PLR) 200226032 and PLR 200326023 for more information.

### Ineligible corporations

Ineligible corporations include the those listed in the table below [§1361(b)(2)].

### Number of shareholders

S corporations must not have more than 100 shareholders. The 100-shareholder limit applies to the number of persons who are shareholders at the same time [Rev Rul 78-390]. Stated another way, more than 100 persons may be shareholders during the taxable year as long as there are not more than 100 shareholders at the same time. This may happen when existing shareholders sell their stock to one or more new shareholders.

For purposes of counting the number of shareholders [§1361(c)]: spouses and their estates count as one shareholder (even if the stock is owned individually); all members of a family (and their estates) count as one shareholder; and all shareholders count as separate shareholders, even if held as tenant in common or joint tenant [Reg. §1.1361-1(e)(1)].

**Note:** The IRS monitors the 100 or less shareholder limit by requiring disclosure of the number of shareholders during any part of the tax year on Line I of page 1 of Form 1120-S.

| Ineligible Corporations | |
|---|---|
| • A financial institution that uses the reserve method of accounting for bad debts | • An insurance company taxed under Subchapter L of the Internal Revenue Code |
| • A domestic international sales corporation (DISC) or former DISC | • A taxable mortgage pool (TMP) as defined in §7701(i)(2)(A) |

## Eligibility to be an S corporation shareholder

Only individuals who are U.S. citizens or residents, decedent's estates, the estate of an individual in bankruptcy, and certain trusts and tax-exempt organizations may be S corporation shareholders [§1361(b)(1)(B)].

If a corporation has an ineligible shareholder, it cannot be an S corporation. Generally S corporation stock cannot be owned by a corporation, partnership, ineligible trust, nonresident alien, LLC, or LLP. Certain single member LLC's can be S corporation shareholders.

## Nonresident alien shareholder

A corporation does not qualify as an S corporation if it has a nonresident alien shareholder [§1361(b)(1)(C)]. A nonresident alien shareholder is an individual who is not a U.S. citizen and whose residence is not within the U.S. (the 50 states and the District of Columbia).

In Ward v. U.S. 48 AFTR 2d 81-5942 an S election was invalid where it was made by a taxpayer who lived with his nonresident alien wife in a foreign country whose laws made the S corporation stock the community property of the spouse.

## One class of stock

S corporations can have only one class of stock. If the corporation has more than one class of stock, it cannot make a valid S election. In general, treat a corporation as having only one class of stock if all outstanding shares of stock of the corporation offer identical rights to distribution and liquidation proceeds [Reg. §1.1361-1(l)(1)]. Shares of common stock can have differences in voting rights and still be considered one class of stock [§1361(c)(4)].

## Advantages and disadvantages of each entity structure

Each entity structure has its own advantages and disadvantages. The chart below (not all inclusive) outlines the key advantages and disadvantages associated with each entity structure.

## C corporation conversion to S corporation

If all the requirements are met, a domestic small business corporation can elect to be an S corporation. The corporation must file Form 2553, *Election by a Small Business Corporation*, to make a valid S election [Reg. §1.1362-6(a)(2)].

For existing C corporations electing S status, Form 2553 must be filed [§1362(b)(1; Reg. §1.1362-6(a)(2)(ii)]: by the 15th day of the third month after the beginning

| Comparison of Advantages and Disadvantages of C Corporation and S Corporation | | |
|---|---|---|
| Item | C corporation | S corporation |
| Taxation | **Advantage:** 21% flat corporate tax rate<br><br>**Disadvantage:** Subject to double taxation | **Advantage:** Pass-through taxation<br><br>**Disadvantage:** Shareholder may be in a tax bracket greater than 21% |
| Ownership restrictions | **Advantage:** No limits on the number of shareholders<br><br>**Advantage:** No restrictions on shareholder types (entities, non-U.S. citizens allowed)<br><br>**Disadvantage:** None | **Advantage:** None<br><br>**Disadvantage:** Limited to 100 shareholders<br><br>**Disadvantage:** Shareholders generally must be U.S. citizens/residents (limited exceptions exist) |
| Stock | **Advantage:** Multiple classes of stock can be issued | **Disadvantage:** Only one class of stock allowed |
| Pass-through loss | **Disadvantage:** Losses cannot pass through to shareholders | **Advantage:** Losses pass through to shareholders, potentially offsetting their other income |
| QBID | **Disadvantage:** Not eligible for 20% deduction | **Advantage:** Could be eligible for up to 20% deduction on QBI |
| Tax year | **Advantage:** Flexibility to use a fiscal tax year end | **Disadvantage:** Generally required to have a Dec. 31 year-end; however, the IRS can approve a fiscal year-end if there is a business purpose or if the S corporation makes an election under §444 |

## Review questions answers on page 21

1. If an existing C corporation makes the S election, which of the following assets is subject to the BIG tax if it was on hand on the effective date of the S election?
   A. Accounts receivable of accrual basis C corporation
   B. Fixed assets with FMV more than its adjusted basis
   C. Fixed assets with FMV less than its adjusted basis
   D. Goodwill owned by the S corporation shareholder

2. When existing C corporation converts to an S corporation, there may be carryforwards to the S corporation years. Which of the following items **cannot** be used to reduce the BIG tax?
   A. NOLs
   B. Capital losses
   C. Business credits
   D. Charitable contribution carryforwards

3. What might be a primary reason a C corporation may consider electing S corporation status?
   A. Potential tax savings
   B. Elimination of the requirement to file a corporate tax return
   C. Ability to have unlimited shareholders
   D. Ability to have a nonresident alien shareholder

of the tax year the election is to take effect, or at any time during the tax year preceding the tax year it is to take effect. If the S election is filed in the current year but after the 15th day of the third month, the S election is generally effective on Jan. 1 of the following tax year [§1362(b)(3)]; however, this will not apply if the corporation qualifies for late S election relief.

At the time Form 2553 is filed, the corporation must designate its chosen accounting period. Generally, an electing S corporation has three choices for an accounting period: conform to the December 31 calendar year as required by §1378; apply for a permitted fiscal year-end based on IRS approval of a business purpose; elect under §444 to use a fiscal year ending on the last day of September, October or November, and become subject to the annual deposit requirement under §7519.

When an existing corporation becomes an S corporation, S status begins on the day following the last day of the C corporation's tax year.

**Example: Beginning of first year**

MPT, Inc. is a C corporation with a fiscal year ending Aug. 31, 2024. MPT decides to become an S corporation and changes to a calendar year. The S corporation year is effective on the day following the last day of the C corporation's normal tax year. The S election would be effective Sept. 1, 2024, if the S election is filed any time from Sept. 1, 2023 (the beginning of the C corporation's tax year), through Nov. 15, 2024 (the 15th day of the third month of the new tax year). The final C corporation return will for the 12-month period ending Aug. 31, 2024. The S corporation's first tax return will cover Sept. 1 through Dec. 31, 2024. The second S corporation return will be for the following calendar year, 2025.

**Note:** If certain requirements are met, an existing C corporation can automatically change its tax year to a calendar year, or other permitted year, then elect S status effective for the tax year immediately following the C corporation's short period [Rev. Proc. 2006-45].

If in the above example, it was determined that all of the requirements of Rev. Proc. 2006-45 were met, then MPT can change its tax year to one beginning Sept. 1, 2024, and ending Dec. 31, 2024. In computing the tax due with this short period return, MPT is required to annualize its taxable income. It would also need to file Form 1128, *Application to Adopt, Change or Retain a Tax Year*, by the due date of the short period, if MPT does not file an extension request. If a six-month extension is requested, Form 1128 must be filed by the extended due date for the short period tax return.

| Requirements to be Met | |
|---|---|
| • The entity intended to be classified as an S corporation, is an eligible entity, and failed to qualify as an S corporation only because the election was not timely | • The entity has reasonable cause for its failure to make the election timely |
| • The entity and all shareholders reported their income consistent with an S corporation election in effect for the year the election should have been made and all subsequent years | • Less than 3 years and 75 days have passed since the effective date of the election (exceptions exist to this requirement when certain conditions are met) |

## Late S election relief

Taxpayers may request relief for a late S election under Rev. Proc. 2013-30 if they meet certain conditions. If they do not qualify for relief under this revenue procedure, they may request a private letter ruling under certain circumstances.

When a corporation fails to file the S election by the deadline, relief may be available under Rev. Proc. 2013-30. To qualify for late S election relief under this revenue procedure, all the requirements listed in the table above must be satisfied.

## Private letter rulings (PLRs)

The IRS no longer issues PLRs with respect to reasonable cause and late S elections (Rev. Proc. 2023-3). However, the IRS previously issued PLRs regarding reasonable cause for late S elections. For example, reasonable cause was established in the following situations: the sole shareholder of the corporation thought the corporation's tax advisor had filed Form 2553 (PLR 200302025); an employee failed to mail Form 2553 to the IRS because they accidentally mailed it to the state department of revenue with the state S election (PLR 9720019); the shareholders intended that the corporation be treated as an S corporation (PLR 201048027).

These PLRs give tax professionals examples of reasonable cause that the IRS accepted in the past. Thus, if the corporation fails to timely file Form 2553 due to oversight or because it thought someone else filed it, presumably, the IRS will continue to accept these explanations as reasonable cause.

**Note:** A new employer identification number (EIN) should not be established for corporations when a corporation changes from a C corporation to an S corporation.

## Items to consider

Some important items to consider when switching from a C corporation to S corporation include the built-in-gains (BIG) tax; last in first out (LIFO) recapture tax; excess net passive investment income tax; and unused net operating losses (NOLs).

Along those lines, if the S corporation will owe a corporate level tax for any tax year, estimated tax payments due to that tax may be required. Generally, an S corporation must make installment payments of estimated tax for the following taxes if the total of these taxes is $500 or more: the tax on BIG; the excess net passive income tax; and the investment credit recapture tax.

The taxes and payments section of Form 1120-S looks as follows:

FIGURE 1

| Tax and Payments | | | | | | |
|---|---|---|---|---|---|---|
| | 23a | Excess net passive income or LIFO recapture tax (see instructions) | 23a | | | |
| | b | Tax from Schedule D (Form 1120-S) | 23b | | | |
| | c | Add lines 23a and 23b (see instructions for additional taxes) | | | 23c | |
| | 24a | Current year's estimated tax payments and preceding year's overpayment credited to the current year | 24a | | | |
| | b | Tax deposited with Form 7004 | 24b | | | |
| | c | Credit for federal tax paid on fuels (attach Form 4136) | 24c | | | |
| | d | Elective payment election amount from Form 3800 | 24d | | | |
| | z | Add lines 24a through 24d | | | 24z | |
| | 25 | Estimated tax penalty (see instructions). Check if Form 2220 is attached ☐ | | | 25 | |
| | 26 | **Amount owed.** If line 24z is smaller than the total of lines 23c and 25, enter amount owed | | | 26 | |
| | 27 | **Overpayment.** If line 24z is larger than the total of lines 23c and 25, enter amount overpaid | | | 27 | |
| | 28 | Enter amount from line 27: **Credited to 2024 estimated tax** **Refunded** | | | 28 | |

A reporting summary is below:

| Summary of Tax Types for Form 1120-S, Lines 23a-c | | |
|---|---|---|
| Tax type | Line number | Description |
| LIFO recapture | 23a | The current years installment is entered on Line 23a and to the left of the total on Line 23a, enter the installment amount and "LIFO tax" |
| Excess net passive investment | 23a | Enter the tax and attach a computation statement |
| BIG | 23b | Enter the BIG tax from Schedule D, Part III, Line 23 |

## BIG

The BIG tax is a corporate level tax on S corporations that dispose of assets that appreciated in value during the years the entity was a C corporation [§1374]. Stated another way, if the fair market value (FMV) of an asset exceeds its adjusted basis on the date the S election became effective, the difference is subject to the BIG tax. If the S corporation acquired an asset with basis determined, in whole or in part, by reference to its basis in the hands of a C corporation, the S corporation can be subject to the BIG tax. In general, the BIG tax does not apply to assets acquired after the effective date of the S election. The purpose of the BIG tax is to prevent corporations that had unrecognized gain on assets during the years it was a C corporation from not paying corporate-level tax on the gain by converting to S status and then distributing those assets.

An S corporation may owe the tax if it has net recognized built-in gain during the recognition period. The recognition period is the 5-year period beginning with the first day of the first year for which the corporation was an S corporation [§1374(d)(7)(A)]. In general, when the S corporation recognizes gain upon the disposition of an appreciated asset within this recognition period, the built-in gain is taxed at the highest corporate tax rate, currently 21%, whether the gain is capital or ordinary.

**Example: Recognition period**

Paws, Inc. has operated as a C corporation and elected S corporation status on Oct. 15, 2020. Paws first day of the recognition period is Oct. 15, 2020, the last day of the recognition period is Oct. 14, 2026 [Reg. §1.1374-1(d)].

The following assets may be subject to the BIG tax if they were on hand when the S election became effective:

- Fixed assets
- Inventory
- Cash-basis receivables
- Intangible assets, including goodwill

The BIG is calculated on Schedule D (Form 1120-S), *Capital Gains and Losses and Built-in Gains*, Part III and reported on page 1, Line 23 b of Form 1120-S.

**Note:** If the S corporation will be subject to the BIG tax, it should have its assets appraised as of the beginning of its first tax year as an S corporation. This is to provide evidence of the value of the assets at the time the C corporation made the S election. This may help avoid having the BIG tax applied to appreciation that occurs after the entity becomes an S corporation. The appraiser should also consider if some intangibles are personal assets of the shareholder, and not a corporate asset. See Martin Ice Cream Co. v. Commissioner [Tax Ct. Dkt. No. 1477-93 (3/17/98)] for further information on goodwill being an asset of the shareholder-employee, not the corporation. To be subject to the BIG tax, the corporation must own the goodwill.

**Example: S corporation subject to BIG tax**

T&T Inc. was originally a C corporation and elected S status. At the time of conversion, T&T held an asset that had a basis of $60,000 ($100,000 cost - $40,000 depreciation) and a FMV of $70,000. Within the recognition period, T&T sells the asset for $70,000. A BIG gain of $10,000 ($70,000 - $60,000) results. This causes a BIG tax of $2,100 ($10,000 x .21). The tax is reported on Form 1120-S, Line 12, taxes and licenses, and Line 23b, tax from Schedule D (Form 1120-S). T&T will pass through a gain of $7,900 ($10,000 - $2,100) to its shareholders where it retains its character as ordinary income (§1245 depreciation recapture income). The appropriate lines from Form 1120-S would be as follows (see Form 1120-S table next page):

| Form 1120-S | |
|---|---|
| Line 4, net gain (loss) from Form 4797, Line 17 | $10,000 |
| Line 12, taxes and licenses | 2,100 |
| Line 22, ordinary income | $7,900 |
| | |
| Line 23b, tax from Schedule D (Form 1120-S) | 2,100 |

The BIG tax, which is calculated on Schedule D, is reported as a deduction and in the tax and payments section.

Remember that only pre-conversion appreciation is subject to the BIG tax.

What would be the impact if, instead of having a $10,000 gain from the sale, the asset was sold for $85,000? The net gain would now be $25,000 ($85,000 - $60,000). However, only $10,000 (the pre-conversion appreciation) would be subject to the BIG tax. At the shareholder level, the gain is not broken out between the BIG portion and the portion that is post S-election gain; $22,900 of ordinary business income ($25,000 net gain - $2,100 tax) would flow to the shareholder.

**Variation:** Going back to the example of the S corporation subject to BIG. What would be the results if the S corporation had allowable depreciation of $12,000 during the year?

The result would be the same. Except there would be a different net gain on Line 4. A gain of $22,000 results ($70,000 sales price - $48,000 adjusted basis ($60,000 - $12,000)) and Line 14 would report depreciation expense of $12,000. All other numbers remain the same. The appropriate lines from Form 1120-S would be as follows:

| Form 1120-S | |
|---|---|
| Line 4, net gain (loss) from Form 4797, Line 17 | $22,000 |
| Line 12, taxes and licenses | 2,100 |
| Line 14, depreciation from Form 4562 | 12,000 |
| Line 22, ordinary income | $7,900 |
| | |
| Line 23b, tax from Schedule D (Form 1120-S) | 2,100 |

The above examples are simple illustrations used to explain the basics of the BIG tax. The concept can be challenging as the BIG tax may apply when the S corporation does not make any unusual asset dispositions. Two common situations are when a cash method corporation collects an accounts receivable that accrued during the time frame it was a C corporation (i.e. cash-basis receivables on hand when the S election became effective) or when an accrual method corporation disposes of inventory that was acquired during the time frame it was a C corporation (i.e. slow-moving inventory that appreciated between the date of purchase and the date the S election became effective).

## LIFO inventories

When a C corporation uses the LIFO inventory method and makes an S election, the corporation must include the LIFO recapture amount in its income. Any tax due on this income is payable over four equal installments. The C corporation must pay the first installment by the due date, not including extensions, of Form 1120 for the corporation's last tax year as a C corporation or for the tax year of the transfer, whichever is applicable. The S corporation must pay each of the remaining installments by the due date, not including extensions, of Form 1120-S for the three succeeding tax years.

This tax is imposed on the corporation before it becomes an S corporation. There is no effect on the income of the S corporation or its shareholders after the S election is effective.

## Passive income

A tax on excess net passive investment income is imposed when the passive investment income of an S corporation exceeds 25% of gross receipts and there are accumulated earnings and profits carried over from its C corporation years. Passive investment income would include dividends, interest, rents, royalties and annuities [§1362(d)]. The tax rate on excess net passive investment income is 21%. There are no carryforwards from C corporation years to offset this tax.

If the S corporation owes the tax for three consecutive years, the S corporation election terminates.

The tax can be avoided by distributing the accumulated earnings and profits to the shareholders; these distributions are taxable to the shareholders. The property earning the passive income could also be distributed to the shareholder(s); there would however be tax consequences depending on the FMV of the asset and its adjusted basis.

**Example:**

Nala Inc. is an S corporation that has accumulated earnings and profits from its C corporation years. For its tax year 2024, it has gross income from its active business of $125,000 and from its passive rental investment of $75,000. For total income of $200,000 ($125,000 + $75,000).

For Nala Inc. to not be subject to the passive investment income tax, the maximum gross receipts it could have would be $50,000 ($200,000 x .25). Nala has $25,000 ($75,000 - $50,000) of excess passive gross receipts.

Assume that Nala has non rental expenses of $169,000 and rental expenses of $21,000. The company's taxable income would be $10,000 ($200,000 - $169,000 - $21,000). The tax is $2,100 ($10,000 x .21). Most software will have an *Excess Net Passive Income Tax Worksheet* for Line 23a that will be used to calculate the excess net passive income tax. See the worksheet below for detail on how the tax was calculated:

FIGURE 2

Form **1120-S** | **Excess Net Passive Income Tax Worksheet** | **2023**

For calendar year 2023 or tax year beginning , ending

Name: Nala, Inc. | Employer Identification Number

**Worksheet for Line 23a**

| | | |
|---|---|---|
| 1 | Enter gross receipts for the tax year (see Section 1362(d)(3)(B) for gross receipts from the sale of capital assets) * | 200,000 |
| 2 | Enter passive investment income as defined in Section 1362(d)(3)(C)* | 75,000 |
| 3 | Enter 25% of line 1. If line 2 is less than line 3, stop here. You are not liable for this tax | 50,000 |
| 4 | Excess passive investment income. Subtract line 3 from line 2 | 25,000 |
| 5 | Enter deductions directly connected with the production of income on line 2 (see Section 1375(b)(2))* | 21,000 |
| 6 | Net passive income. Subtract line 5 from line 2 | 54,000 |
| 7 | Divide amount on line 4 by amount on line 2 | 33.33 % |
| 8 | Excess net passive income. Multiply line 6 by line 7 | 17,998 |
| 9 | Enter taxable income (see instructions for taxable income below) | 10,000 |
| 10 | Enter smaller of line 8 or line 9 | 10,000 |
| 11 | Excess net passive income tax. Enter 21% of line 10. Enter here and on line 23a, page 1, Form 1120-S | 2,100 |

The tax impact is similar to that of the BIG tax; the excess net passive investment income tax is a reduction of the net passive investment income (i.e. rental income in this example).

The calculation of the income for 2024 is as follows:

| | Business Income | Rental Income |
|---|---|---|
| Gross receipts | $125,000 | $75,000 |
| Total deductions | 169,000 | 21,000 |
| Net passive investment income tax | N/A | 2,100 |
| Net income (loss) | ($44,000) | $51,900 |

## Unused losses and credits

Generally, there are no carryforwards and no carrybacks between C and S corporation tax years [§1371(b)]. Nonetheless, net operating losses (NOLs), capital losses, and business credits carried over from C corporation tax years can be used to reduce the BIG tax [§1374(b)(2)]. These carryover items cannot be used to reduce the tax on excess net passive income.

Any other loss carryforwards (i.e., charitable contribution carryforwards under §170(d)(2)) are not allowed as deductions against net recognized BIG [Reg. §1.1374-5(a)].

### NOLs

If the C corporation has unused NOLs, the losses cannot offset S corporation income and cannot pass through to the shareholders. They can only be used as deductions against net recognized BIG for purposes of the BIG tax.

**Example: NOL and BIG**

Rally, Inc. is an S corporation that previously was a C corporation. Rally has a net recognized BIG of $350,000 for the tax year, before taking into account any NOL carryforwards. Rally has a NOL carryforward of $150,000 from a prior C corporation year. The entity is subject to a BIG tax on $200,000 ($350,000 - $150,000). Rally's BIG tax will be $42,000 ($200,000 x .21).

**Scenario change:** What would happen if the NOL carryforward to the tax year is $500,000?

Only $350,000 of the NOL carryforward can be used to offset the entire net recognized BIG of $350,000 so that no BIG tax would be required by Rally for the year. The $150,000 balance of the NOL carryforward ($500,000 - $350,000) can be carried forward to the next tax year.

Similar rules apply for capital loss carryforwards. Capital loss carryforwards from a C corporation year can be used to offset that part, if any, of the net recognized BIG that is a capital gain.

### Tax credits

If there are tax credits that are carried forward from a C corporation year, they cannot be used to reduce any S corporation tax liability, except for the BIG tax [§1374(b)(3)]. The business credit carryovers under §39 are the only credit carryovers allowed to offset a BIG tax liability.

## Review answers

1. A. Incorrect. Accounts receivable of a cash basis C corporation are subject to the BIG tax. An accrual basis C corporation already recognized the income as a C corporation.
   B. **Correct.** An appreciated fixed asset with a FMV more than its adjusted basis is subject to the BIG tax.
   C. Incorrect. Appreciated assets are subject to the BIG tax, so an asset with a FMV less than its adjusted basis is not subject to the BIG tax.
   D. Incorrect. Goodwill must be owned by the corporation to be subject to the BIG tax

2. A. Incorrect. NOLs carried over from C corporation years can be used to reduce the BIG tax.
   B. Incorrect. Capital losses carried over from C corporation years can be used to reduce the BIG tax.
   C. Incorrect. Business credits carried over from C corporation years can be used to reduce the BIG tax.
   D. **Correct.** Charitable contribution carryforwards carried over from C corporation years cannot be used to reduce the BIG tax.

3. A. **Correct.** Potential tax savings may be a primary reason a C corporation may consider electing S corporation status.
   B. Incorrect. S corporations are required to file Form 1120-S, *U.S. Income Tax Return for an S corporation*.
   C. Incorrect. One of the requirements to be an S corporation is that they must not have more than 100 shareholders.
   D. Incorrect. A corporation does not qualify as an S corporation if it has a nonresident alien shareholder.

### Section 179

An unused §179 deduction cannot be carried into an S corporation year. It is not available to either the S corporation or its shareholders.

## Schedule L

Schedule L (Form 1120) and Schedule L (Form 1120-S) are the *Balance Sheets per Books* for each entity. Although similar, they are not identical. There are two main differences between them. First, Form 1120 contains lines (Line 22 a and b) for both preferred and common stock; Form 1120-S has only one line (Line 22) for capital stock. This is because an S corporation can only have one class of stock. Second, Form 1120 has lines (Lines 24 and 25) for both appropriated and unappropriated retained earnings. Form 1120-S has one line (Line 24) for only one retained earning amount.

**Note:** Appropriated retained earnings are earnings that are earmarked by the board of directors for a specific purpose, such as debt reduction, research and development costs, and equipment purchases.

If a C corporation has appropriated earnings and then elects to become an S corporation, appropriated and unappropriated earnings are combined into one line, Line 24, on Form 1120-S. A record of appropriated and unappropriated retained earnings should be kept during the period that the corporation is an S corporation.

**Example: Schedule L when a C corporation elects to become an S corporation**

Jingle Jangle, Inc. has been a C corporation for many years and on Jan. 1, 2023, elected S corporation status. On this date, Jingle Jangle's books showed common stock of $1,000, appropriated retained earnings of $75,000 and unappropriated retained earnings of $25,000. The final C corporation return reflected the same amounts as shown below:

FIGURE 3

| Schedule L | Balance Sheets per Books | Beginning of tax year | |
|---|---|---|---|
| | Assets | (a) | (b) |
| 1 | Cash | | 101,000 |
| 2a | Trade notes and accounts receivable | | |
| b | Less allowance for bad debts | ( ) | |
| 3 | Inventories | | |
| 4 | U.S. government obligations | | |
| 5 | Tax-exempt securities (see instructions) | | |
| 6 | Other current assets (att. stmt.) | | |
| 7 | Loans to shareholders | | |
| 8 | Mortgage and real estate loans | | |
| 9 | Other investments (attach stmt.) | | |
| 10a | Buildings and other depreciable assets | | |
| b | Less accumulated depreciation | ( ) | |
| 11a | Depletable assets | | |
| b | Less accumulated depletion | ( ) | |
| 12 | Land (net of any amortization) | | |
| 13a | Intangible assets (amortizable only) | | |
| b | Less accumulated amortization | ( ) | |
| 14 | Other assets (attach stmt.) | | |
| 15 | Total assets | | 101,000 |
| | Liabilities and Shareholders' Equity | | |
| 16 | Accounts payable | | |
| 17 | Mortgages, notes, bonds payable in less than 1 year | | |
| 18 | Other current liabilities (att. stmt.) | | |
| 19 | Loans from shareholders | | |
| 20 | Mortgages, notes, bonds payable in 1 year or more | | |
| 21 | Other liabilities (attach statement) | | |
| 22 | Capital stock: a Preferred stock | | |
| | b Common stock | 1,000 | 1,000 |
| 23 | Additional paid-in capital | | |
| 24 | Retained earnings—Appropriated (att. stmt.) Stmt 1 | | 75,000 |
| 25 | Retained earnings—Unappropriated | | 25,000 |
| 26 | Adjustments to SH equity (att. stmt.) | | |
| 27 | Less cost of treasury stock | | ( ) |
| 28 | Total liabilities and shareholders' equity | | 101,000 |

This will be combined into one number on Form 1120-S.

FIGURE 4

Form **1120-S**

## Retained Earnings Reconciliation Worksheet

For calendar year 2023 or tax year beginning , ending

**2023**

Name: Jingle Jangle, Inc.

Employer Identification Number

### Schedule L - Retained Earnings

| | |
|---|---|
| Retained Earnings - Unappropriated (Accumulated E&P) | 100,000 |
| Accumulated Adjustments Account | 40,000 |
| Undistributed Previously Taxed Income | 0 |
| Other Adjustments Account | 0 |
| Retained Earnings Timing Differences | -5,000 |
| Schedule L, Line 24 - Retained Earnings | 135,000 |

### Schedule M-2 - Retained Earnings

| | Accumulated Adjustments Account | Undistributed Previously Taxed Income | Accumulated Earnings and Profits | Other Adjustments Account | Retained Earnings Timing Differences | Total Retained Earnings |
|---|---|---|---|---|---|---|
| Beginning of Year | 0 | 0 | 100,000 | 0 | 0 | 100,000 |
| Ordinary Income (Loss) | 50,000 | | | | | 50,000 |
| Other Additions | | | | | | |
| Other Reductions | | | | | 5,000 | 5,000 |
| Distributions | 10,000 | | | | | 10,000 |
| End of Year | 40,000 | 0 | 100,000 | 0 | -5,000 | 135,000 |

**Note:** The 2023 Form Schedule L on the previous page is prior to making the conversion to an S corporation in the software. The beginning balance reflected would be the Dec. 31, 2022, ending balance for the final year of the C corporation.

Both C corporation retained earnings accounts are combined on the beginning Schedule L balance sheet of the corporation's first Form 1120-S. On its 2023 Form 1120-S, Jingle Jangle shows retained earnings of $100,000 ($75,000 + $25,000) on Line 24.

Jingle Jangle has $50,000 in net income (book and tax) and the shareholder received a distribution of $10,000. Jingle Jangle's ending retained earnings is $140,000 ($75,000 + 25,000 + 50,000 - 10,000) as reflected in the retained earnings reconciliation worksheet (see Figure 4 above).

Page 4 of the Form 1120-S for 2023 would look as follows (see Figure 5 on the next page).

The retained earnings amount reported on Schedule L, Line 24, is book retained earnings, which may be different from the accumulated adjustments account (AAA) balance or the sum of the AAA, other adjustments account (OAA) and previously taxed income (PTI) balances. These accounts are used to determine the taxability of distributions to shareholders. AAA, OAA and PTI balances on Schedule M-2, *Analysis of Accumulated Adjustments Account, Shareholders' Undistributed Taxable Income Previously Taxed, Accumulated Earnings and Profits, and Other Adjustments Account*, are reported using tax amounts.

In smaller companies, there may be no book to tax differences. In that case, the retained earnings balance will be made up of: (1) appropriated and unappropriated retained earnings at the date the S election is effective, plus (2) cumulative changes in the AAA, OAA and PTI balances, less (3) dividend distributions of accumulated earnings and profits (AE&P) while an S corporation.

FIGURE 5

Form 1120-S (2023) Jingle Jangle, Inc. Page 4

| Schedule K | Shareholders' Pro Rata Share Items *(continued)* | | Total amount |
|---|---|---|---|
| Other Information | 17a Investment income | 17a | |
| | b Investment expenses | 17b | |
| | c Dividend distributions paid from accumulated earnings and profits | 17c | |
| | d Other items and amounts (attach statement) | | |
| Recon-ciliation | 18 **Income (loss) reconciliation.** Combine the total amounts on lines 1 through 10. From the result, subtract the sum of the amounts on lines 11 through 12d and 16f | 18 | 50,000 |

| Schedule L Balance Sheets per Books | Beginning of tax year | | End of tax year | |
|---|---|---|---|---|
| **Assets** | (a) | (b) | (c) | (d) |
| 1 Cash | | 101,000 | | 141,000 |
| 2a Trade notes and accounts receivable | | | | |
| b Less allowance for bad debts | ( ) | | ( ) | |
| 3 Inventories | | | | |
| 4 U.S. government obligations | | | | |
| 5 Tax-exempt securities (see instructions) | | | | |
| 6 Other current assets (attach statement) | | | | |
| 7 Loans to shareholders | | | | |
| 8 Mortgage and real estate loans | | | | |
| 9 Other investments (attach statement) | | | | |
| 10a Buildings and other depreciable assets | | | | |
| b Less accumulated depreciation | ( ) | | ( ) | |
| 11a Depletable assets | | | | |
| b Less accumulated depletion | ( ) | | ( ) | |
| 12 Land (net of any amortization) | | | | |
| 13a Intangible assets (amortizable only) | | | | |
| b Less accumulated amortization | ( ) | | ( ) | |
| 14 Other assets (attach statement) | | | | |
| 15 Total assets | | 101,000 | | 141,000 |
| **Liabilities and Shareholders' Equity** | | | | |
| 16 Accounts payable | | | | |
| 17 Mortgages, notes, bonds payable in less than 1 year | | | | |
| 18 Other current liabilities (attach statement) | | | | |
| 19 Loans from shareholders | | | | |
| 20 Mortgages, notes, bonds payable in 1 year or more | | | | |
| 21 Other liabilities (attach statement) | | | | |
| 22 Capital stock | | 1,000 | | 1,000 |
| 23 Additional paid-in capital | | | | |
| 24 Retained earnings | | 100,000 | | 140,000 |
| 25 Adjustments to shareholders' equity (attach statement) | | | | |
| 26 Less cost of treasury stock | | ( ) | | ( ) |
| 27 Total liabilities and shareholders' equity | | 101,000 | | 141,000 |

Form **1120-S** (2023)

Notice that the prior year retained earnings balance has been combined into one amount on Line 24.

Page 5 of the Form 1120-S would look as follows (see Figure 6 on the next page).

Schedule M-1 reconciles income (loss) per the books with income (loss) per the return. The purpose of Schedule M-2 is to track income, losses and separately stated items the shareholder should report on their tax returns [IRM 4.10.3.7]. Schedule M-2 is showing that Jingle Jangle's AAA is $40,000 and its AE&P is $100,000. Together these items equal the $140,000 in retained earnings. This agrees with the retained earnings calculation discussed above when there are no book to tax differences.

In general, the AAA is the accumulated undistributed net income of the S corporation for tax years beginning after 1982. S corporations with AE&P must maintain the AAA to determine the tax effect of distributions during S corporation years and the post-termination period.

Some entities may have book to tax differences, usually due to depreciation. What would the retained earnings look like when there are book to tax differences?

Using the similar facts as the early example:

**Example: Schedule L when there are book to tax depreciation differences**

Jingle Jangle has $45,000 (instead of $50,000) in net income per books. The $5,000 difference was caused by depreciation expense. The S corporation return deducted $7,000 in depreciation, while the books showed

FIGURE 6

Form 1120-S (2023) Jingle Jangle, Inc. Page 5

**Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return**

**Note:** The corporation may be required to file Schedule M-3. See instructions.

| | | | | | |
|---|---|---|---|---|---|
| 1 | Net income (loss) per books | 50,000 | 5 | Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize): a Tax-exempt interest $ | |
| 2 | Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize): | | | | |
| 3 | Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 16f (itemize): a Depreciation $ b Travel and entertainment $ | | 6 | Deductions included on Schedule K, lines 1 through 12, and 16f, not charged against book income this year (itemize): a Depreciation $ | |
| | | | 7 | Add lines 5 and 6 | |
| 4 | Add lines 1 through 3 | 50,000 | 8 | Income (loss) (Schedule K, line 18). Subtract line 7 from line 4 | 50,000 |

**Schedule M-2 Analysis of Accumulated Adjustments Account, Shareholders' Undistributed Taxable Income Previously Taxed, Accumulated Earnings and Profits, and Other Adjustments Account** (see instructions)

| | | (a) Accumulated adjustments account | (b) Shareholders' undistributed taxable income previously taxed | (c) Accumulated earnings and profits | (d) Other adjustments account |
|---|---|---|---|---|---|
| 1 | Balance at beginning of tax year | | | 100,000 | |
| 2 | Ordinary income from page 1, line 22 | 50,000 | | | |
| 3 | Other additions | | | | |
| 4 | Loss from page 1, line 22 | ( ) | | | |
| 5 | Other reductions | ( ) | | | ( ) |
| 6 | Combine lines 1 through 5 | 50,000 | | 100,000 | |
| 7 | Distributions | 10,000 | | | |
| 8 | Balance at end of tax year. Subtract line 7 from line 6 | 40,000 | | 100,000 | |

Form **1120-S** (2023)

FIGURE 7

Form **1120-S** **Retained Earnings Reconciliation Worksheet** **2023**

For calendar year 2023 or tax year beginning , ending

Name: Jingle Jangle, Inc. Employer Identification Number

**Schedule L - Retained Earnings**

| | |
|---|---|
| Retained Earnings - Unappropriated (Accumulated E&P) | 100,000 |
| Accumulated Adjustments Account | 40,000 |
| Undistributed Previously Taxed Income | 0 |
| Other Adjustments Account | 0 |
| Retained Earnings Timing Differences | -5,000 |
| Schedule L, Line 24 - Retained Earnings | 135,000 |

**Schedule M-2 - Retained Earnings**

| | Accumulated Adjustments Account | Undistributed Previously Taxed Income | Accumulated Earnings and Profits | Other Adjustments Account | Retained Earnings Timing Differences | Total Retained Earnings |
|---|---|---|---|---|---|---|
| Beginning of Year | 0 | 0 | 100,000 | 0 | 0 | 100,000 |
| Ordinary Income (Loss) | 50,000 | | | | | 50,000 |
| Other Additions | | | | | | |
| Other Reductions | | | | | 5,000 | 5,000 |
| Distributions | 10,000 | | | | | 10,000 |
| End of Year | 40,000 | 0 | 100,000 | 0 | -5,000 | 135,000 |

depreciation expense of $12,000. The shareholder received a distribution of $10,000. Jingle Jangle's ending retained earnings is $135,000 ($75,000 + 25,000 + 45,000 - 10,000) as reflected on the retained earnings reconciliation worksheet (Figure 7) on the previous page.

**Note:** Notice that the Schedule M-2 retained earnings reconciliation worksheet will keep track of the retained earnings timing differences if it is selected in the software and if your software has that capability. The Schedule M-2 that is filed with the tax return will not have a column for the retained earnings timing differences.

The relevant pages of Form 1120-S for 2023 would look like Figure 8 below and Figure 9 on the next page.

**Note:** As this example illustrates, retained earnings on Schedule L is a book number that frequently will not tie to the amounts on Schedule M-2, Line 8 a-d, which are tax numbers. The main difference will be the timing differences between book and tax. For example, if book depreciation is less than tax depreciation, the retained earnings on the balance sheet will be larger than these balances because there is less depreciation (more profit) for book purposes than for tax purposes (more depreciation and less profit). In this example, there is $5,000 more book depreciation than tax depreciation, so Schedule L retained earnings ($135,000) is lower than the Schedule M-2, Line 8 a and c ($140,000), because there is less profit per the books ($45,000) than for the tax return ($50,000). The $5,000 difference is a timing difference as eventually the tax depreciation will be larger than the book depreciation.

When conversion to an S corporation is not a good solution, the C corporation can convert to an LLC and continue to operate in that form. In the LLC format, the entity could operate as a sole proprietorship, general

FIGURE 8

Form 1120-S (2023) Jingle Jangle, Inc. Page **4**

| Schedule K | Shareholders' Pro Rata Share Items *(continued)* | | Total amount |
|---|---|---|---|
| Other Information | 17a Investment income | 17a | |
| | b Investment expenses | 17b | |
| | c Dividend distributions paid from accumulated earnings and profits | 17c | |
| | d Other items and amounts (attach statement) | | |
| Recon-ciliation | 18 **Income (loss) reconciliation.** Combine the total amounts on lines 1 through 10. From the result, subtract the sum of the amounts on lines 11 through 12d and 16f | 18 | 50,000 |

| **Schedule L** Balance Sheets per Books | Beginning of tax year | | End of tax year | |
|---|---|---|---|---|
| **Assets** | (a) | (b) | (c) | (d) |
| 1 Cash | | 61,000 | | 108,000 |
| 2a Trade notes and accounts receivable | | | | |
| b Less allowance for bad debts | ( ) | | ( ) | |
| 3 Inventories | | | | |
| 4 U.S. government obligations | | | | |
| 5 Tax-exempt securities (see instructions) | | | | |
| 6 Other current assets (attach statement) | | | | |
| 7 Loans to shareholders | | | | |
| 8 Mortgage and real estate loans | | | | |
| 9 Other investments (attach statement) | | | | |
| 10a Buildings and other depreciable assets | 50,000 | | 50,000 | |
| b Less accumulated depreciation | (10,000) | 40,000 | (22,000) | 28,000 |
| 11a Depletable assets | | | | |
| b Less accumulated depletion | ( ) | | ( ) | |
| 12 Land (net of any amortization) | | | | |
| 13a Intangible assets (amortizable only) | | | | |
| b Less accumulated amortization | ( ) | | ( ) | |
| 14 Other assets (attach statement) | | | | |
| 15 Total assets | | 101,000 | | 136,000 |
| **Liabilities and Shareholders' Equity** | | | | |
| 16 Accounts payable | | | | |
| 17 Mortgages, notes, bonds payable in less than 1 year | | | | |
| 18 Other current liabilities (attach statement) | | | | |
| 19 Loans from shareholders | | | | |
| 20 Mortgages, notes, bonds payable in 1 year or more | | | | |
| 21 Other liabilities (attach statement) | | | | |
| 22 Capital stock | | 1,000 | | 1,000 |
| 23 Additional paid-in capital | | | | |
| 24 Retained earnings | | 100,000 | | 135,000 |
| 25 Adjustments to shareholders' equity (attach statement) | | | | |
| 26 Less cost of treasury stock | | ( ) | | ( ) |
| 27 Total liabilities and shareholders' equity | | 101,000 | | 136,000 |

Form **1120-S** (2023)

FIGURE 9

Form 1120-S (2023) Jingle Jangle, Inc. Page 5

**Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return**

**Note:** The corporation may be required to file Schedule M-3. See instructions.

| | | | |
|---|---|---|---|
| 1 Net income (loss) per books | 45,000 | 5 Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize): a Tax-exempt interest $ | |
| 2 Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize): | | | |
| 3 Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 16f (itemize): a Depreciation $ 5,000 b Travel and entertainment $ | 5,000 | 6 Deductions included on Schedule K, lines 1 through 12, and 16f, not charged against book income this year (itemize): a Depreciation $ | |
| | | 7 Add lines 5 and 6 | |
| 4 Add lines 1 through 3 | 50,000 | 8 Income (loss) (Schedule K, line 18). Subtract line 7 from line 4 | 50,000 |

**Schedule M-2 Analysis of Accumulated Adjustments Account, Shareholders' Undistributed Taxable Income Previously Taxed, Accumulated Earnings and Profits, and Other Adjustments Account** (see instructions)

| | **(a)** Accumulated adjustments account | **(b)** Shareholders' undistributed taxable income previously taxed | **(c)** Accumulated earnings and profits | **(d)** Other adjustments account |
|---|---|---|---|---|
| 1 Balance at beginning of tax year | | | 100,000 | |
| 2 Ordinary income from page 1, line 22 | 50,000 | | | |
| 3 Other additions | | | | |
| 4 Loss from page 1, line 22 | ( ) | | | |
| 5 Other reductions | ( ) | | | ( ) |
| 6 Combine lines 1 through 5 | 50,000 | | 100,000 | |
| 7 Distributions | 10,000 | | | |
| 8 Balance at end of tax year. Subtract line 7 from line 6 | 40,000 | | 100,000 | |

Form **1120-S** (2023)

partnership or limited partnership. We will discuss operating as a sole proprietorship. Operating as an LLC will eliminate the double taxation that C corporations face; however, it will involve liquidating the C corporation and may result in tax at both the corporate and shareholder level. Converting to an LLC will also maintain liability protection for the owners. However, depending on the situation, the cost of the conversion can be high and therefore prohibitive for many. However, if the corporation or its shareholders have a NOL or capital loss carryforwards, they could be utilized to offset the corporate or shareholder level gain.

## Conversion of a C corporation to a LLC

When an existing C corporation converts to an LLC, the corporation is deemed to have liquidated by distributing all of its assets to the shareholders. The shareholders then transfer those assets to the new LLC in exchange for interests in the LLC.

The deemed liquidation results in tax consequences at two levels. At the corporate level, the entity is treated as if it sold all of its assets for fair market value (FMV) [§336]. This results in C corporation gain which is subject to the corporate income tax. At the shareholder level, the shareholder recognizes gain or loss for the difference between the FMV of the assets deemed received in liquidation, less any corporate level tax, and their basis in the corporate stock [§331]. Stated another way, the distribution of assets in deemed liquidation is treated at the corporate level in the same way as if the assets were sold for cash and the proceeds distributed in exchange for the shareholder shares. The shareholder would have taxable gain or loss on the difference between the liquidation proceeds and the basis of their shares.

**Note:** Whether the C corporation sells all of its assets and distributes the proceeds in liquidation or distributes all of its assets in liquidation, the tax consequences to the corporation and its shareholders are substantially the same.

### Example: C corporation converted to LLC

PQL, a C corporation, has made the decision to convert to an LLC. It has assets with a FMV of $300,000 and a tax basis of $100,000. The only shareholder has a basis in the corporate stock of $60,000. Assume the shareholder has a capital gains rate of 20%. The combined tax on the conversion would be calculated as follows (see table at top of the next page).

| Combined Tax on Conversion | | | |
|---|---|---|---|
| Event | Amount | Tax rate | Liability |
| Deemed sale of asset at FMV | $300,000 | | |
| Tax basis of asset | 100,000 | | |
| Corporate level gain | 200,000 | | |
| Corporate level tax | | 21% | $42,000 |
| Liquidating distribution to shareholder ($200,000 - $42,000) | 158,000 | | |
| Shareholder's basis in corporate stock | 60,000 | | |
| Shareholder's capital gain | 98,000 | | |
| Shareholder's tax on capital gain | | 20% | 19,600 |
| Total tax liability | | | $61,600 |

As the above example illustrates, the deemed liquidation of the corporation will result in double taxation, when there are appreciated assets, for federal income tax purposes – one on the corporation's distribution of the assets and one on the distribution to the shareholders who are deemed to receive the assets in corporate liquidation prior to the assets being contributed to the new LLC.

Some states offer a conversion option where a C corporation may become an LLC under state law without a physical transfer of the assets (also called a statutory conversion). In some states, the two transfers of the assets of the corporation may carry state property tax implications. By doing this conversion, the property tax implication can be eliminated. There would still be double taxation from a federal tax perspective as discussed above.

Some may be tempted to set up an LLC and begin doing business out of it without formally liquidating the corporation. The tax code has addressed this issue with §482, the step transaction doctrine, and the business purpose doctrine. Section 482 authorizes the IRS to adjust the income, deductions, credits, or allowances of commonly controlled taxpayers to prevent evasion of taxes or to clearly reflect their income. The step transaction doctrine is a rule of substance over form. The business purpose doctrine provides that if the transaction has no substantial business purpose other than to avoid tax, the tax law will not regard the transaction.

Converting from a C corporation to an LLC is complicated and may involve the assistance of other professionals, including a tax attorney.

In some situations, converting the C corporation to an S corporation may be the route to go. This will eliminate the issue of double taxation by reporting the corporation's income on the shareholder's personal tax return. The conversion process will require the filing of Form 2553, which must be submitted within the required time frame to be considered timely, although relief may be available for a late filed form. The corporation should also receive acknowledgement and approval of the S corporation election from the IRS. It will also need to file the last C corporation return (Form 1120) by the due date or extended due date. Also, file the S corporation return (Form 1120-S) by the due date or extended due date. The filing of the initial Form 1120-S return will finalize the change of the entity's filing requirement on the IRS's records.

For additional information on the issues facing S corporations, see the October 2024 CPE article *Essentials of S corp Compliance*. Tax professionals who work with S corporations and their shareholders need a solid grasp of several key concepts, including reasonable compensation, shareholder basis, and distribution payments. These three concepts are covered in the article. ▸

## CPE exam

The following exam will provide one hour of federal tax law credit with the IRS or CTEC. The exam questions are taken from the article, Entity Conversions.

The exam must be taken online. This CPE is available for Professional and Premium level members. Go to natptax.com/tpj to register. To qualify for CPE credit, you must answer all exam questions and score a 70% or higher. You have unlimited attempts to pass the exam. Please contact Member Services with any questions at 800-558-3402, ext. 3, or at natp@natptax.com.

1. If an S corporation is subject to the built-in-gains (BIG) tax, the tax rate for 2024 is
   A. 15%
   B. 20%
   C. 21%
   D. 35%

2. Which of the following would be things to consider when deciding if the entity should switch from a C corporation to an S corporation?
   A. Built-in-gains tax
   B. Excess net passive investment income tax
   C. Unused net operating losses
   D. All of the above

3. In which of the following situations would the C corporation not want to elect to be taxed as an S corporation?
   A. The corporation has two shareholders, both of whom are U.S. citizens, and they want take advantage of the pass-through taxation benefits.
   B. The corporation expects to have significant passive income.
   C. The corporation pays dividends and wants to benefit from avoiding double taxation.
   D. The shareholder is in a tax bracket lower than 21%.

4. What form is filed by a corporation if it elects to be an S corporation?
   A. Form 2553
   B. Form 1128
   C. Form 1120
   D. Form 1040

5. Which of the following statements is correct?
   A. If the C corporation has unused NOLs, the losses cannot offset S corporation income and cannot pass through to shareholders.
   B. If the C corporation has unused NOLs, the losses can offset S corporation income and can pass through to shareholders.
   C. Charitable contribution carryforwards under §170(d)(2) are allowed as deductions against net recognized built in gains.
   D. If the S corporation will owe a corporate level tax for any tax year, estimated tax payments due to that tax are never required.

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# Gone Phishing

## Avoid Getting Caught in These Scams

**By Brad Messner, EA, MBA**
**CEO of Financial Guardians**

We have all received those suspicious e-mails; some clearly look fake, but many others look legitimate and are increasingly becoming more dangerous. These phishing attacks are a critical security threat, especially in industries handling sensitive personal and financial information. In fact, the IRS warned tax professionals nearly half a dozen things in the last twelve months about phishing schemes that exploit human behavior and technical vulnerabilities. Understanding how phishing works on a technical level is essential for tax professionals who need to defend their client data and financial records against cybercriminals.

### What is phishing?

Phishing is a form of social engineering that manipulates human psychology to extract sensitive information, but behind these simple deceptions lie more sophisticated technical mechanisms. Phishing attacks typically involve forged emails, spoofed domain names or cloned websites designed to appear authentic. These technical features trick users into interacting with malicious content, often leading to compromised systems. In the tax preparation industry, phishing schemes aim to steal client financial records, W-2s or credentials for accessing financial systems, putting both you and your clients at risk.

Phishing has commonly involved the use of e-mail as the communication method compromised; however, other methods exist such as smishing (attacking through SMS or text messages) and vishing (attacking through audio or voice channels). For the purposes of this article, phishing includes email, text and voice attacks. If you recall the September 2023 cyber attack against MGM Resorts, that attack was initialized by information gathered from vishing.

### Types of phishing attacks

- **Email phishing:** Email phishing remains the most prevalent attack method. Tax preparers are often sent emails that contain code hiding malicious links, or that use specially crafted "From" addresses to mimic legitimate contacts. In technical terms, these emails may involve techniques such as email spoofing, where the attacker manipulates the sender address in the email header to appear as though it is coming from a legitimate source (for example: natptaxes.com instead of natptax.com). Additionally, some attackers use encoded URLs or URL shorteners to mask the true destination of a phishing link. Tax preparers must be aware that even trusted email domains can be exploited using these tactics.
- **Spear phishing:** Spear phishing is a more targeted and technically sophisticated form of phishing. Attackers use broad data sources (public data repositories, social media access and artificial intelligence) to gather information about specific individuals, such as tax preparers or their clients. Using data gathered from social media, professional networks or even past breaches, attackers craft highly personalized emails. These emails may include the exact tax document names or payment histories, making them appear highly credible. Advanced spear phishing attacks may use customized malicious attachments. The tax preparation industry is highly susceptible and frequently targeted by these attacks.
- **Whaling:** Whaling is a form of spear phishing in which the target is typically a high-profile individual, perhaps a celebrity or wealthy individual or family. These individuals are known targets and working with them increases the overall risk brough upon the firms they work with, sometimes requiring specific insurance riders to account for their increased risk.

- **Business email compromise (BEC):** BEC attacks, where cybercriminals compromise legitimate business email accounts by using typically through credential theft, are continuing to grow in this industry. Once the attacker gains control of a trusted account, they can access client documents or other confidential files within the organization. The most common attack in 2024 involved bank account switching – where an attacker updates client back account information to have refunds deposited into their account instead.


## Typical warning signs you might be targeted

Recognizing some of the common warning signs that you might be getting targeted by a phishing attack is important to ensure your ongoing protection. Some key warnings signs include:

- Suspicious or unknown email senders (including spoofed addresses that appear legitimate on initial review such as irs-gov.com instead of irs.gov)
- Generic greetings instead of a direct reference to you
- Urgent and out of place language
- Unexpected and unusual attachments or links
- Poor grammar or spelling mistakes
- Unexpected login pages or popups
- Requests for data out of the ordinary course of business
- Any message not expected or received unexpectedly

## Protecting yourself against phishing schemes

Given the ever-evolving landscape or technology and threats today, there is no 100% foolproof system to guarantee yourself and your firm safety from phishing, or for that matter, any attacks. However, here is a collection of tools and systems you can put into place to mitigate and minimize your exposure.

- **Educate your staff:** While educating staff on recognizing phishing attempts is crucial, technical training can enhance their ability to spot advanced phishing attacks. Teach employees about technical red flags such as mismatched email domains, hidden links behind masked URLs and the use of unusual attachment types (.zip, .iso). Training staff to examine email headers, identify suspicious source IP addresses and utilize email clients with built-in phishing protection can mitigate a large number of attacks. There are dozens of companies who conduct ongoing training and testing of yourself and employees that you can partner with for thorough staff evaluation.
- **Multi-factor authentication (MFA):** MFA with token-based or app-based authentication is a cornerstone of phishing defense, but using token-based MFA or app-generated codes (rather than SMS-based authentication) provides additional security. Text or email-based authentication has an increased risk of being intercepted and stolen. Token-based authentication, especially those relying on physical security tokens like YubiKeys, is much harder for attackers to compromise. The FTC requires that all systems storing or accessing personally identifiable information be protected with MFA-based technologies.
- **Anti-phishing tools and filters:** Many modern email clients and security software come equipped with anti-phishing tools that scan incoming emails for suspicious elements. These systems use machine learning models and signature-based detection to identify common phishing patterns. In fact, both Microsoft and Google have deployed enhanced anti-phishing filters their e-mail products in 2024.
- **Encrypted data:** Phishing attacks that lead to malware infections or ransomware incidents can compromise sensitive client data. Implementing data encryption, both at rest and in transit, adds another layer of security. Should a phishing attack result in a data breach, encrypted data remains inaccessible to attackers without the decryption key.
- **Network segmentation:** Separating your personal and business activity across segmented (or divided) networks reduces the risk that your

personal activity, or the activity of others on your network, introduces a risk from a phishing attack. Especially if you have employees or staff who work from home; one of their family members falling victim to a phishing attack could compromise your data, if on a shared network.

- **Minimize high-risk system usage:** Reducing your usage of high-risk and systems typically susceptible to attacks, such as e-mail and texting, will also drastically mitigate your risks. These systems are dated technology and are continually targeted as easily breachable tools. Newer, more secure technology is easily available and can be deployed with any firm with minimal effort. If higher-risk system usage is continued, adding additional security protocols, such as not permitted attachments or not allowing active links, could be an improved step above a fully open environment.

## Improving your technology portfolio

As phishing attacks continue to evolve with new technical tactics and strategies, we must adopt a proactive, multi-layered security approach. By integrating both human and technical safeguards – such as advanced MFA solutions, network segmentation, anti-phishing tools and staff training on recognizing the technical nuances of phishing attemptss – tax professionals can significantly reduce the risk of falling victim to these attacks. In an industry where trust and data security are paramount, investing in technical defenses against phishing is essential for maintaining the integrity of tax preparation services. ▶

### About the Author

Brad is the third-generation owner of M & J Tax Service and the firm's first enrolled agent. He has 27 years of experience specializing in farm, research credit, and corporate tax preparation as well as an in-depth understanding of data security, due diligence and entity selection. Brad also has over 20 years of experience developing security solutions for small and large global organizations. He is the founder of Financial Guardians, LLC. NATP members receive a 30% discount off the standard Guardian Tier Membership: https://www.yourfinancialguardians.com/bundles/natp

# How To

# Year-End Wrap-Up

By Sheri Fronsee, CPA, and Kris Siolka, EA
NATP Tax Content Specialists

As we prepare for tax season, let's review the 2024 tax rates, highlight the impact of tax law changes during the past year and cover information you need to know.

## 2024 tax rates

There are seven federal individual income tax rates for tax year 2024: 10%, 12%, 22%, 24%, 32%, 35% and 37%. The tax rates are dependent upon taxable income and filing status.

## Capital gains and qualified dividends tax rates

The capital gains and qualified dividends rates will remain unchanged at 0%, 15% and 20%, with an additional net investment income tax (NIIT) rate of 3.8% for taxpayers who meet the NIIT threshold requirements. Maximum unrecaptured §1250 gain due to depreciation remains at 25%, and collectible and antique capital gain remains at 28%.

## Personal exemption and standard deduction

Personal exemption deductions have been suspended from 2018 through 2025. However, the standard deduction amount for each filing status nearly increased. 2024 amounts are shown in the table below.

While the dependency exemption deduction under §151 is reduced to zero from 2018 through 2025, this reduction isn't considered for other purposes of the tax code, such as who is a qualifying relative for family credit purposes or for head of household (HOH) status. This amount is $5,050 for 2024.

Table 1: Standard Deduction Amounts for 2024

| Filing status | Amount |
|---|---|
| MFJ, QSS | $29,200 |
| MFS | $14,600 |
| HOH | $21,900 |
| S | $14,600 |
| 65+/blind additional standard deduction (MFJ, QSS) | $1,550 |
| 65+/blind additional standard deduction (S, HOH) | $1,950 |
| Dependent personal exemption | Greater of:<br>$1,300 or<br>$450 + earned income |

## Child tax credit, additional child tax credit and other dependents credit

For 2024, the child tax credit (CTC) is $2,000 per qualifying child (under age 17) and has a refundable component or the additional child tax credit (ACTC) of up to $1,700, subject to modified adjusted gross income (MAGI) phase-outs. To be eligible for the CTC, each qualifying child claimed on the tax return must have a Social Security number (SSN) and the CTC is also available for married filing separately (MFS) returns.

In the case of divorced or separated parents, if the child is treated as the qualifying child of the noncustodial parent under the rules for children of divorced or separated parents, only the noncustodial parent can claim the CTC for that child.

MAGI phase-outs for the CTC, which are not indexed for inflation, begin with MAGI of more than $200,000 ($400,000 MFJ).

Dependents not eligible for the CTC may be eligible for the other dependents credit (ODC) of $500. Dependents qualifying for the ODC include qualifying children age 17 and older, dependents without an SSN and qualifying relatives.

**Reminder:** The CTC, ACTC and ODC fall under the due diligence requirements for filing Form 8867, *Paid Preparer's Due Diligence Checklist*, each year.

## Itemized deductions

**Medical expenses.** Medical expenses are subject to 7.5% of AGI [§213(a)].

**State and local income tax deduction (SALT).** The SALT deduction for state and local income taxes or general sales taxes (if elected), real estate taxes and personal property taxes is limited to a total of $10,000 ($5,000, MFS) through 2025.

**Mortgage interest.** The allowable ceiling for qualified mortgage interest on a taxpayer's acquisition indebtedness is $750,000 ($375,000 MFS) unless the mortgage was incurred on or before Dec. 15, 2017. Mortgages obtained prior to this date are considered grandfathered debt under the $1 million indebtedness limit. The deduction for interest on home equity debt is also suspended for tax years 2018-2025. Because of this suspension, the only way for home equity indebtedness to be qualified debt is for it to be secured by the home, be used to buy, build, or substantially improve the property and be within the acquisition debt limitations.

**Charitable contribution deduction.** The amount of the deduction for charitable contributions of cash to 50% charities is limited to 60% of AGI through 2025. Depending on the type of property given and the type of organization it is given to, the charitable deduction may be limited to 50%, 30% or 20% of AGI. A higher limit applies to certain qualified conservation contributions.

**Casualty and theft loss.** Personal casualty and theft losses an individual sustains in a tax year beginning after 2017 and before 2026 are deductible only to the extent that the losses are attributable to a federally declared disaster.

For casualty losses in a federally declared disaster that occurred in an area warranting public or individual assistance (or both), taxpayers can choose to treat the casualty loss as having occurred in the year immediately preceding the tax year in which the disaster loss was sustained. The loss can be claimed as a deduction on that return or an amended return for the preceding tax year.

If the loss deduction is more than the taxpayer's income, the result may be a net operating loss (NOL).

**Employee business expenses.** Through 2025, the deduction for employee business expenses reported on Form 2106, *Employee Business Expenses*, is only available to members of the Armed Forces reservists, qualified performing artists, fee-basis state or local government officials, and employees with impairment-related work expenses.

**Gambling losses and expenses.** Gambling losses of recreational gamblers are deductible on Schedule A (Form 1040), but only to the extent of winnings, which are included in taxable income on Schedule 1 (Form 1040), Part I, Line 8b. The IRS requires taxpayers to maintain a log of winnings and losses as documentation.

## Moving expenses

The moving expense deduction on Form 3903, *Moving Expense*, has been suspended for all taxpayers except active members of the Armed Forces who move due to a change in military orders. The moving expense deduction is currently suspended through 2025 for any other taxpayers receiving reimbursement for what would have been otherwise qualified moving expenses.

## Alimony

Effective for any divorce or separation instrument executed after Dec. 31, 2018, alimony received is not taxable and alimony paid is not deductible. This also applies to pre-2019 divorce decrees amended after Dec. 31, 2018, if the new agreement expressly provides that the TCJA rules apply. For divorces executed and finalized before 2019, alimony received is taxable and alimony paid is deductible.

When filing Form 1040, taxpayers receiving taxable alimony must include the amount received and the date of the divorce on Schedule 1 (Form 1040), Part I, Lines 2a and 2b. Those paying deductible alimony report the amount paid, the recipient's SSN and the date of the original divorce on Schedule 1 (Form 1040), Part II, Lines 19a, 19b and 19c.

## Alternative minimum tax (AMT)

The AMT exemption amounts for 2024 are shown below.

Table 2: AMT Exemption Amounts and Phase-Out Ranges for 2024

| Filing status | Exemption amount | Phase-out ranges |
|---|---|---|
| MFJ, QSS | $133,300 | $1,218,700-$1,751,900 |
| S, HOH | $85,700 | $609,350-$952,150 |
| MFS | $66,650 | $609,350-$875,950 |

## §529 plan distributions

Distributions from qualified tuition plans (QTPs) under §529 consist of two components: (1) return of investment or basis and (2) earnings. Earnings on distributions used to pay for post-secondary education are nontaxable to the extent they are used for qualified higher education expenses. Distributions in excess of the student's qualified higher education expenses are taxable to the extent of earnings distributed.

Taxpayers may also take distributions of up to $10,000 each year from §529 plans to pay for education costs, such as tuition and related fees, paid to a public, private, or religious elementary or secondary educational institution.

Plan holders can use distributions to pay for tuition and qualified expenses of apprenticeship programs and can withdraw a lifetime maximum of $10,000 to pay down qualified student loan debt of the designated beneficiary.

Taxpayers may roll over within 60 days funds from a §529 plan to an Achieving a Better Life Experience (ABLE) account without penalties. This rollover must be made to an ABLE account that is owned by the designated beneficiary of the §529 plan or to a member of the designated beneficiary's family.

Starting in 2024, if the 529 plan has unused funds, the beneficiary can roll over up to a maximum lifetime limit of $35,000 into a Roth IRA. To qualify, the 529 plan must be owned for at least 15 years, any contributions made within the last five years are not eligible to be rolled over, and the rollover is limited to the beneficiary's annual Roth IRA contribution limit ($7,000 for 2024, ($8,000 if age 50 or over in 2024)). Therefore, it will take at least five years to roll over the entire $35,000.

## Discharged student loan debt

Under §108(f)(5), gross income does not include any amount that would be taxable cancellation of debt income from the discharge of certain student loans in 2021-2025.

These loans include:

- Loans for postsecondary educational expenses if loans were made, insured or guaranteed by the U.S., a state or an eligible educational institution
- Private education loans
- Loans from an educational organization described in §170(b)(1)(A)(ii) that meet certain requirements
- Loans from a tax-exempt organization under §501(a) to refinance a student loan

## Student loan interest

The maximum deduction is $2,500.

For 2024, the deduction starts to phase out when MAGI exceeds $80,000 ($165,000 if MFJ). A taxpayer cannot take a student loan interest deduction if their MAGI is $95,000 ($195,000 if MFJ) or more.

A student loan interest deduction is not allowed if the student loan interest is paid with the 529 plan distribution.

## Estates and gifts

For tax year 2024, the exclusion for decedents is $13,610,000 with an applicable credit of $5,389,800. The FMV date of death basis rules remain in effect.

For 2024, the annual exclusion for gifts is $18,000. However, the annual exclusion for gifts to noncitizen spouses is limited to $185,000, instead of unlimited gifting between U.S. citizen spouses.

For estates not required to file Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, the surviving spouse of a deceased taxpayer has nine months, or the last day of the extension period if the return was extended, to make the portability election. This allows the surviving spouse to apply the deceased spousal unused exclusion amount (DSUE) to their own transfers during life and at death.

However, Rev. Proc. 2022-32 extended the date to make the portability election up until the fifth anniversary of the decedent's date of death, provided certain requirements are met.

## Qualified business income deduction (QBID)

The QBID under §199A for an eligible taxpayer is the lesser of (1) their combined qualified business income (QBI) or 20% of their taxable income before the QBID less net capital gain for the year.

For 2024, the taxpayer's QBID is reduced or eliminated if their taxable income exceeds the threshold amounts of $383,900 for those filing MFJ, or $191,950 for those filing S, HOH, MFS or QSS.

Taxpayers at or below the thresholds may be allowed the full 20% deduction. A partial deduction is allowed for taxpayers falling within the phase-in range. However, the deduction for those taxpayers exceeding the top of the phase-in range will be eliminated completely. These phase-in ranges are shown in the table below.

Table 3: QBID Phase-In Range for 2024

| Filing status | Phase-out ranges |
|---|---|
| MFJ | $383,900-$483,900 |
| S, HOH, MFS, QSS | $191,950-$241,950 |

## Don't ignore BOI filing requirements

As the year draws to a close, tax professionals should be mindful of the upcoming requirement to file Beneficial Ownership Information (BOI) reports as mandated by the *Corporate Transparency Act*. Entities subject to this regulation such as LLCs and other entities established through their state secretary of state's office, including many tax professionals, must ensure that their BOI reports are submitted to the Financial Crimes Enforcement Network (FinCEN) by the designated deadline. This requirement is part of broader efforts to enhance transparency in corporate ownership. For more information, tax professionals can refer to the FinCEN FAQs on this issue at https://www.fincen.gov/sites/default/files/shared/BOI-FAQs-QA-508C.pdf.

## Tax professionals need a WISP

Professionals should be aware of the importance of having a Written Information Security Plan (WISP) in place. A WISP outlines the procedures and policies for protecting sensitive client information, ensuring compliance with data security regulations, and safeguarding against data breaches. In an era where cyber threats are increasingly prevalent, having a well-documented WISP is essential for maintaining client trust and meeting regulatory requirements. Now is an opportune time to review and update your WISP to reflect current practices and emerging threats.

## Stay vigilant against scams

The IRS urges taxpayers to be on the lookout for unexpected scam phone calls, text messages and emails from anyone claiming to be collecting on behalf of the IRS. Recent news about tax scams and consumer alerts are available at www.irs.gov/uac/tax-scams-consumer-alerts. Tax scams generated by new AI tools are especially troublesome because they look professionally composed and are specifically tailored to trick vulnerable taxpayers.

Due to the continuation of scams involving individuals who impersonate IRS agents and request immediate payment, the IRS will do everything it can to help taxpayers avoid confusion and ensure they understand their rights and tax responsibilities, especially when it assigns cases to a private collection agency.

Even with private debt collection, taxpayers shouldn't receive unexpected phone calls, text messages or emails from the IRS demanding payment. When taxpayers owe tax, the IRS always sends several collection notices through the mail before making phone calls.

## Affordable care subsidies

The premium tax credit (PTC) is available to individuals whose household income is between 100% and 400% of the federal poverty line. However, for 2021-2025, the credit may be allowed when household income exceeds 400% of the federal poverty line. Also, health care costs are limited to 8.5% of family household income for Marketplace-purchased health coverage only [§36B(b)(3)(A)(iii)].

## Energy efficient home improvement credit

The energy efficient home improvement credit includes property placed in service after Dec. 31, 2022, and before Jan. 1, 2033 (§25C). The credit amount is 30% of the sum of the amount paid or incurred by the taxpayer for qualified energy efficiency improvements installed during the year and the amount of the residential energy property expenditures paid or incurred by the taxpayer during that year.

The maximum annual limit is $1,200 for certain property in the aggregate. In addition, there are separate annual limits of $600 for qualified energy property, $600 for windows and skylights, $250 for each exterior door ($500 in total for all exterior doors) and $150 for home energy audits. A $2,000 annual limit applies in the aggregate to amounts paid for specified heat pumps, heat pump water heaters, and biomass stoves and boilers. The energy efficient home improvement credit is claimed on Form 5695, *Residential Energy Credits*, Part II.

## Residential clean energy credit

The residential clean energy credit includes solar, fuel cell, wind, geothermal and qualified battery storage [§25D(a)].

The credit amounts are as follows:

- 30% for property placed in service after Dec. 31, 2021, and before Jan. 1, 2033
- 26% for property placed in service after Dec. 31, 2032, and before Jan. 1, 2034
- 22% for property placed in service after Dec. 31, 2033, and before Jan. 1, 2035

The residential clean energy credit is claimed on Form 5695, Part I.

## Clean vehicle credit

The credit for new clean vehicles can be as high as $7,500 (§30D). A qualified vehicle must have final assembly in North America, meet critical mineral or battery component requirements and have a minimum battery capacity of seven kilowatt hours. The seller must provide a report to the taxpayer and the IRS. The clean vehicle credit is claimed on Form 8936, *Clean Vehicle Credit*, and Schedule A (Form 8936), *Clean Vehicle Credit Amount*.

Additionally, the credit requires the manufacturer's suggested retail price (MSRP) for vans, SUVs and pickup trucks cannot exceed $80,000 ($55,000 for any other vehicle).

In 2024, taxpayers can elect to transfer the credit to the dealer to reduce the purchase price. However, if their MAGI exceeds the limit, they must repay it. Schedule A (Form 8936) is used to reconcile the credit. Make sure to request Form 15400, *Clean Vehicle Seller's Report*, from your client.

No credit is allowed if the taxpayer's MAGI for the current year or preceding year (whichever is less) exceeds the following threshold amounts:

- $300,000 (MFJ, QSS)
- $225,000 (HOH)
- $150,000 (all others)

## Credit for previously owned clean vehicle

This credit is for taxpayers who purchase a previously owned clean vehicle after Dec. 31, 2022, and before Jan. 1, 2033 (§25E). The credit is the lesser of $4,000 or 30% of the vehicle's sales price. The sales price cannot exceed $25,000 and the transaction must be through a dealer. The purchasing taxpayer is the first qualified buyer to claim the credit since Aug. 16, 2022, other than its original user. The previously owned clean vehicle credit is claimed on Form 8936 and Schedule A (Form 8936).

No credit is allowed if the taxpayer's MAGI for the current year or preceding year (whichever is less) exceeds the following threshold amounts:

- $150,000 (MFJ, QSS)
- $112,500 (HOH)
- $75,000 (all others)

A previously owned clean vehicle is a motor vehicle:

- With a model year that is at least two years earlier than the calendar year in which the taxpayer acquires it
- That was originally used by someone other than the taxpayer
- Acquired by the taxpayer in a qualified sale
- Most of the same requirements apply but not all

This credit can also be transferred to the dealer, as such client's should provide Form 15400 and reconciliation is required on Schedule A (Form 8936)

## Mortgage forgiveness debt relief

The maximum amount of discharged debt on a principal residence through foreclosure or debt restructuring that may be excluded from income under §108(a)(1)(E) is $750,000 ($375,000 MFS) through tax year 2025.

## Earned income tax credit (EIC)

The maximum EIC and phase-out amounts are shown in the following table.

| Table 4: EIC for 2024 | | | |
|---|---|---|---|
| | | AGI phase-out amount | |
| Qualifying children | Max EIC | Single, HOH, QSS | MFJ |
| 0 | $632 | $18,591 | $25,511 |
| 1 | $4,213 | $49,084 | $56,004 |
| 2 | $6,960 | $55,768 | $62,688 |
| 3 or more | $7,830 | $59,899 | $66,819 |

The disqualified investment income limit for 2024 is $11,600.

## Child and dependent care credit

The eligible expense limits are $3,000 for one eligible dependent and $6,000 for two or more eligible dependents. Additionally, the maximum credit rate is 35% for taxpayers whose AGI is $15,000 or less.

The exclusion for employer-provided dependent care assistance is $5,000 ($2,500 MFS).

## Flexible spending arrangements (FSA)

For 2024, the contributions dollar limit to health FSAs is $3,200. If the cafeteria plan permits the carryover of unused amounts, the maximum carryover amount is $640.

## Closing

Thank you for your continued support of NATP! We wish you a prosperous new year and another successful filing season.

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# Taxes for Disabled Veterans

By Kathy Morgan, EA, USTCP

One of the tax topics I specialize in at my practice is military affairs, including active duty, reserve, national guardsmen, retirees and veterans. In the November article, we covered the different types of income received by military personnel as well as deductions available. In this article will cover disability compensation and preparing the return for those recipients.

## Types of Disability Compensation

There are several different types of disability compensation for retired military members. They are treated in different manners depending on when the disability was awarded, who it was awarded to and the type of award.

Three of these are very common. Treatment of all these types of disabilities is covered in IRM Section 21.6.6.2.19 (May 8, 2023). We will go through each of the following awards and how to handle the amended returns for back-dated awards and the current-year award.

- Veterans Administration (VA) disability award (Rev. Rul. 78-161, Cod. Sec. 104(a)(4), and Title 38 U.S.C. 3010(a))
- Concurrent retirement and disability payments (CRDP) (IRM Section 21.6.6.2.19)
- Combat related special compensation (CRSC) (IRM Section 21.6.6.2.19)

### VA disability award

By far the most common award is one of a disability percentage rating from the VA. These awards can be given to veterans whether they are receiving a military longevity retirement pension or not. Awards can take years to be approved and are often backdated with the veteran getting a large lump sum payment. If the veteran appeals a compensation award and is subsequently awarded a higher percentage that may also be backdated and affect a prior tax year.

It is important to understand that the VA disability percentage has absolutely no relation to the military retiree's amount of retirement pay. The VA disability percentage of 50% is **not** 50% of the amount on the DFAS 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* The VA has a rating payment scale based on the percentage rating; the website is in the resources section.

VA disability compensation is non-taxable to the veteran or survivor, and they will not receive any end of the year tax reporting documents. They will receive, one or more times a year, a report showing any changes due to cost-of-living adjustments (COLA) or other changes to their monthly benefit.

For income tax purposes, unless the veteran is also receiving a pension from the military (DFAS) for longevity, we don't add anything to the income on the tax return. We do need to keep in mind that this will affect the general sales tax option on Schedule A. The amount of non-taxable VA benefits needs to be added to the total income when figuring the safe harbor general sales taxes based on the place the taxpayer lived.

It is important to communicate to the client that these adjustments are a one-time thing unless they get an increase taking them from 50% or below to over 50% in the future. This is not something that will be adjusted annually as DFAS makes the adjustment before issuing the 1099-R.

### Concurrent retirement and disability payments (CRDP)

CRDP is a program that started phasing in during 2004 over a 10-year period for veterans with a disability percentage of over 50%. This program allows them to receive their military retirement and their disability compensation without one offsetting the other.

Each year from 2004-2014, the offset from the retired pay by the VA went down to being completely phased out after 2014. This program does not apply to any veteran with 50% or less disability rating. They will continue to have retirement pay offset. There are other programs in the works currently to correct this situation for all disabled veterans, but they are not yet in place.

### Combat related special compensation (CRSC)

CRSC is relatively new. We have been starting to see more of them over the last several years. It is important that your veteran knows if they are receiving CRDP or CRSC as they are treated differently and reported to the veteran differently. CRSC is paid by the military retirement people (DFAS), not the VA.

Once DFAS determines that a veteran is eligible for both CRDP and CRSC they are offered a choice of which one to pick and can change that choice once a year. This is all done at DFAS and will affect the veterans DFAS 1099-R.

Other than the original award notification from DFAS, which is usually a postcard with no monetary information on it, the veteran will have an award letter showing his percentage of CRSC award percentage and the effective date. This percentage **is** a direct percentage of the retiree's monthly retirement pay.

## How To Prepare/Amend the Tax returns

When the veteran is granted a VA disability percentage during the year and/or it is backdated into previous tax years, this is where the tax professional must have specific information to prepare the return and any amendments correctly.

We will go through those steps separately for the filing of the original return in the year of the award and the filing of prior year amendments based on a back dated award.

When the veteran is awarded VA disability compensation, they will receive a letter like in Figure 1. This letter is an example of a veteran having his percentage raised; but it works the same way as an original award.

Important items to note for the filing of the tax return are the date of the award, the file number, the monetary calculations and the signature page. You will need copies of all of these when you file the return and/or amendment to attach to the return. The return may have to be mailed into the IRS, due to the attachments, unless your software allows PDF files to be filled with Form 8453, *U.S. Individual Income Tax Transmittal for an IRS e-file Return*.

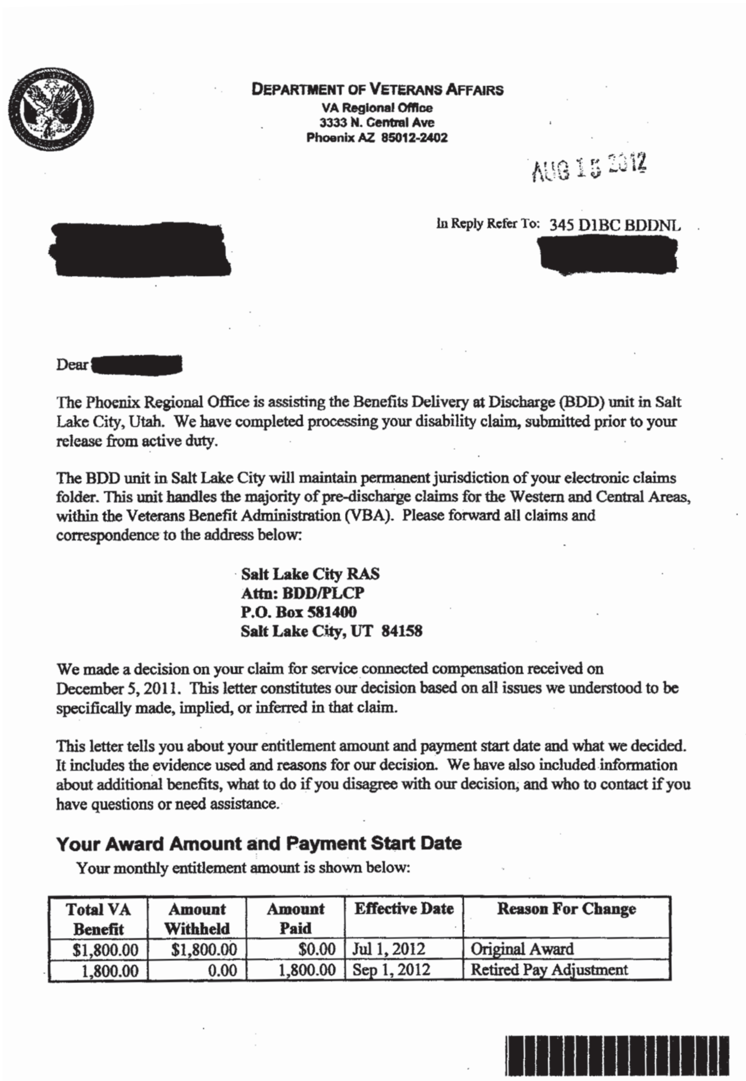
Keep in mind the adjustments and amendments below only apply to a veteran who is receiving a 1099-R, from DFAS for time in service as they adjust the calculations. Veterans who are not receiving a pension for military time in service have no adjustments or amendments.

The information you need to calculate the adjustment on the current year's tax return is listed in the first four columns of the chart included in the letter.

- Item 1. This is the total rate of VA disability compensation pay that the veteran was entitled to based on the new/updated award.
- Item 2. This is the amount of the VA income that the veteran ***did not*** receive because it was offset by the taxable military retired pay.
- Item 3. This is the amount of ***VA non-taxable*** income the veteran received in that time frame.
- Item 4. This is the effective date of payments for the amounts in item 1-3.

**Note:** It is important to remember that when dealing with the VA, dates on the letters are misleading. The effective date of July 1 is not actually paid to the veteran until Aug. 1, so always keep that in mind when adding the amounts for adjustments. This is especially critical if the dates cross the calendar year line. (Title 38 U.S.C. 5111).

FIGURE 1



DEPARTMENT OF VETERANS AFFAIRS
VA Regional Office
3333 N. Central Ave
Phoenix AZ 85012-2402

AUG 15 2012

[redacted]

In Reply Refer To: 345 D1BC BDDNL
[redacted]

Dear [redacted]

The Phoenix Regional Office is assisting the Benefits Delivery at Discharge (BDD) unit in Salt Lake City, Utah. We have completed processing your disability claim, submitted prior to your release from active duty.

The BDD unit in Salt Lake City will maintain permanent jurisdiction of your electronic claims folder. This unit handles the majority of pre-discharge claims for the Western and Central Areas, within the Veterans Benefit Administration (VBA). Please forward all claims and correspondence to the address below:

**Salt Lake City RAS**
**Attn: BDD/PLCP**
**P.O. Box 581400**
**Salt Lake City, UT 84158**

We made a decision on your claim for service connected compensation received on December 5, 2011. This letter constitutes our decision based on all issues we understood to be specifically made, implied, or inferred in that claim.

This letter tells you about your entitlement amount and payment start date and what we decided. It includes the evidence used and reasons for our decision. We have also included information about additional benefits, what to do if you disagree with our decision, and who to contact if you have questions or need assistance.

**Your Award Amount and Payment Start Date**

Your monthly entitlement amount is shown below:

| Total VA Benefit | Amount Withheld | Amount Paid | Effective Date | Reason For Change |
|---|---|---|---|---|
| $1,800.00 | $1,800.00 | $0.00 | Jul 1, 2012 | Original Award |
| 1,800.00 | 0.00 | 1,800.00 | Sep 1, 2012 | Retired Pay Adjustment |


## Original tax return – year of award

It is important to note that until the VA/CRDP award has been processed, the military retirement (DFAS) 1099-R will reflect the complete amount of pension the taxpayer received for the year. DFAS will not go back and correct or "back out" the amount of the pension that should have been non-taxable from the first of the year until the award date. That is where the tax preparer comes in.

In the year of the original award or updated award, the original Form 1040 should be completed as follows:

1. Enter all reporting documents just as they are received, including the DFAS 1099-R.
2. Using the following formula, from the above sample letter, ensuring you count the right number of months based on the note above, determine what the adjustment to the amount on the DFAS 1099-R should be:
   a. Amount withheld (Item 3) X eligible months in the year = adjustment (There will sometimes be multiple line changes for the same year, repeat and add the total.)

**Example**

In the sample letter on the prior page, for tax year 2012 the taxpayer had $1,800 withheld from July 1 through Sept. 1, 2012. Remember the July 1 payment was received in August and the change showing Sept. 1 occurred on Oct. 1. So, for the 2012 tax year the calculations are as follows: $1,800 x 2 months = $3,600 which is the adjustment on Schedule 1 (Form 1040), *Additional Income and Adjustments to Income*.

b. Place the total amount on the other income line of the 1040 as a negative number with the identifier “VA Disability”

c. Complete the return as normal and prepare for mailing if you are not able eFile

d. Attach a copy of the 1099-R from DFAS and all other reporting documents that are normally required

e. Attach a copy of the first page, all pages with monetary computations and the signature page of the VA award letter

f. Mark the top of the 1040 and the VA award letter with the term “VA Disability Award”

g. Make sure the primary SSN is on all pages of the return and all attachments

h. Receive signatures from everyone and mail the return 1040, Page 1

FIGURE 2

| Income | | | | | | |
|---|---|---|---|---|---|---|
| Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld. | 1a | Total amount from Form(s) W-2, box 1 (see instructions) | | | 1a | 25000 |
| | b | Household employee wages not reported on Form(s) W-2 | | | 1b | |
| | c | Tip income not reported on line 1a (see instructions) | | | 1c | |
| | d | Medicaid waiver payments not reported on Form(s) W-2 (see instructions) | | | 1d | |
| | e | Taxable dependent care benefits from Form 2441, line 26 | | | 1e | |
| | f | Employer-provided adoption benefits from Form 8839, line 29 | | | 1f | |
| If you did not get a Form W-2, see instructions. | g | Wages from Form 8919, line 6 | | | 1g | |
| | h | Other earned income (see instructions) | | | 1h | |
| | i | Nontaxable combat pay election (see instructions) | 1i | | | |
| | z | Add lines 1a through 1h | | | 1z | |
| Attach Sch. B if required. | 2a | Tax-exempt interest | 2a | b Taxable interest | 2b | |
| | 3a | Qualified dividends | 3a | b Ordinary dividends | 3b | |
| Standard Deduction for— | 4a | IRA distributions | 4a | b Taxable amount | 4b | |
| • Single or Married filing separately, $13,850 | 5a | Pensions and annuities | 5a | b Taxable amount | 5b | 17000 |
| • Married filing jointly or Qualifying surviving spouse, $27,700 | 6a | Social security benefits | 6a | b Taxable amount | 6b | |
| • Head of household, $20,800 | c | If you elect to use the lump-sum election method, check here (see instructions) ☐ | | | | |
| • If you checked any box under *Standard Deduction*, see instructions. | 7 | Capital gain or (loss). Attach Schedule D if required. If not required, check here ☐ | | | 7 | |
| | 8 | Additional income from Schedule 1, line 10 | | | 8 | |
| | 9 | Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income** | | | 9 | 42000 |
| | 10 | Adjustments to income from Schedule 1, line 26 | | | 10 | (3600) |
| | 11 | Subtract line 10 from line 9. This is your **adjusted gross income** | | | 11 | 38400 |
| | 12 | **Standard deduction or itemized deductions** (from Schedule A) | | | 12 | |
| | 13 | Qualified business income deduction from Form 8995 or Form 8995-A | | | 13 | |
| | 14 | Add lines 12 and 13 | | | 14 | |
| | 15 | Subtract line 14 from line 11. If zero or less, enter -0-. This is your **taxable income** | | | 15 | |

**For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 11320B Form **1040** (2023)

FIGURE 3

| | | | | | |
|---|---|---|---|---|---|
| u | Wages earned while incarcerated | 8u | | | |
| z | Other income. List type and amount: VA DISABILITY | 8z | (3600) | | |
| 9 | Total other income. Add lines 8a through 8z | | | 9 | |
| 10 | Combine lines 1 through 7 and 9. This is your **additional income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8 | | | 10 | (3600) |

**For Paperwork Reduction Act Notice, see your tax return instructions.** Cat. No. 71479F **Schedule 1 (Form 1040) 2023**

Don't forget to check that the adjustment is carried to the state returns correctly. All states do things differently as well as differing software.

**Example:** In my home state of Louisiana, we must make an adjustment on the LA 540 Schedule E so that the adjustment is not "double dipped" out of the taxable income. The starting point for the LA return is the federal AGI and military retirement is deducted on Schedule E. Normally you would just put the amount of retirement on the DFAS 1099-R on the Schedule E, however, in this case, the starting point already has the negative adjustment for the VA award in it, so you must "add" that back into the state return or the taxpayer gets twice the deduction.

You also must watch out if the taxpayer is over 65 because the software wants to take any pension that is leftover after the other exclusions and subtract up to $6,000 for the taxpayer because of age, again double dipping the VA adjustment.

This is a great place for you to show your expertise and let the clients know that we are so much more than data entry clerks, while still letting the software do the heavy lifting for us.

## How to amend a prior year return

Now we face the problem of amending prior year returns when an award is backdated into a prior tax year. One of the great things about VA disability/CRDP awards is they can be amended back up to five tax years including the year of the award but ***must be filed within one year of the award*** to include normally closed years [§6511(d)(8)].

So, if the veteran received the award on a letter dated June 2023 and the award was backdated to February 2019, the tax returns to tax year 2018 may be amended, until June 2024, even though some of those years may normally be considered closed. Any tax year prior to the five-year statute may not be amended for a credit or refund. Your state may or may not follow the extension of time to file an amendment.

The process is basically the same as doing the current year award.

a. Complete the amended state return if necessary
b. Complete the first part of the amendment (putting the original amounts in Column A) and then make the same calculations as in 2(a) and 2(b) above. Pay close attention to the dates and the note starting on page 42 about how to calculate dates for VA awards.
c. Make sure you double check and see if the change in the AGI affects other things you may not be changing specifically (i.e., taxable Social Security, itemized deductions, credits, etc.)
d. For the explanation on Form 1040-X put a statement like the following:

   "Taxpayer received a backdated VA Disability Award dated XX XXX 2023. The award letter is attached. Calculations for the adjustment are as follows: Six months of offset @ $XX + six months of offset @ $XX = $XXX. All changes to the return flow from the adjustment to AGI based on this calculation."

When you put the amended return together for mailing make sure you write "Retroactive VA Disability Award" on the top of Form 1040-X, all pages and attachments as well as the primary SSN on all pages of the packet. If the adjustment has affected other things, like additional schedules and worksheets, make sure you attach them even if it were a worksheet, you would not normally send with an original return.

## Special rules for CRSC returns

The same rules about Form 1099-R apply for a CRSC award regarding the adjustment of the award years. DFAS will not adjust the 1099-R to back out the backdated award amount.

To compute the adjustment for the year of the award you must know the percentage award and the award date from the letter stating it is a CRSC award. Once you have that information the calculation of the adjustment for the individual tax years is as follows:

Total monthly pension (if the veteran has received the pension for the whole tax year simply divide the Box 1 of the 1099R amount by 12) X CRSC percentage award X number of months received CRSC in the tax year. Unlike the VA or CDRP awards this percentage is a direct percentage of the retired member's pension.

After that, the preparation of the original or amended tax returns are done just like described above, including entering the DFAS 1099-R just as received, except instead of indicating "VA Disability Award" you will indicate "CRSC Award" on the top of all pages of the return and all attachments, attach all regular documentation plus the award letter and/or postcard.

## Summary

Once again, I can't stress enough, if you deal with military folks of any kind, Pub. 3, *Armed Forces Tax Guide*, is a must-have for all of you. Get familiar with the various special circumstances dealing with the military member, veteran or retiree and their families.

There is a lot of incorrect information out there floating around about taxes and the military, especially disability awards, make sure you can help your clients do the correct thing the first time around.

## Websites and links of interest

The following are some links and websites of interest that may help you with researching tax items involving military members, veterans and retirees.

Veterans Administration Compensation website:

http://www.benefits.va.gov/compensation/

http://www.dfas.mil/retiredmilitary/disability/disability.html

## Acronyms

- **LES** – leave and earnings statement (military version of a paycheck stub)
- **RAS** – retiree account statement
- **HOR** – home of record
- **DFAS** – defense finance and accounting service
- **MSRRA** – Military Spouse Residency Relief Act of 2009
- **YTD** – year to date
- **TSP** – Thrift Savings Plan (government version of a 401(k))
- **VA** – Veterans Administration
- **COLA** – cost of living adjustment
- **CRDP** – concurrent retirement and disability payments (commonly referred to as concurrent receipt)
- **CRSC** – combat-related special compensation

# Monitoring Your Client's IRS Notices and Account Activity

By Jim Buttonow, CPA/CITP, and Madison Whitfield, EA

It is quite common for taxpayers, and their tax professionals, to help their clients with IRS on issues outside of filing a tax return. In fact, IRS surveys show that over 40% of taxpayers have to work with the IRS outside of filing to get their account information, answer questions about tax issues, or respond to a notice.

Tax professionals are often relegated to be reactive to client questions about a notice or specific information related to their account activity at the IRS. Taxpayers have access to their tax information via the IRS Taxpayer Online Account. However, very few of them utilize the account, especially if they rely on a tax professional for their tax and compliance needs.

To improve transparency into a client's compliance and IRS activity, tax professionals can be authorized to proactively monitor their clients' notices and accounts. More and more, tax professionals are electing to offer monitoring as part of their year-round services. This eliminates the need for clients to alert their tax pro of any IRS issues. With monitoring services, the tax pro is independently notified of any notice activity or transactions on the client's IRS account. As a result, the tax pro can provide a higher quality of service and take a more proactive, effective role in resolving issues, helping keep the client in good standing with the IRS.

## What is IRS Notice and IRS Account Monitoring?

Tax pros can use IRS Notice and Account Monitoring for all types of taxpayers, including individual, business, payroll and specialty tax clients.

IRS Notice Monitoring allows the tax pro and/or their firm to get copied on client IRS notices. Most notices will come to the tax pro at the same time that the client receives it. IRS notices are usually an effective alert of an account discrepancy or issue, such as incorrect estimated tax payments reported on a tax return. IRS notices also alert a tax pro about IRS compliance activity such as collection, non-filing, audit and underreporter (CP2000) notices. Notices also alert tax pros of client penalties.

IRS Account Monitoring uses IRS transcripts to notify the tax pro of updates and changes to the client's IRS account. Account monitoring requires periodic retrieval and analysis of the client's IRS transcripts. Confirmation of return filing, payments and refunds are common-use cases for monitoring, but it can also alert a tax pro of other activity, such as audit selection, income mismatch and CP2000 notices, return adjustments and compliance issues and changes.

IRS Notice Monitoring requires authorization from the client to be copied on their notices for specific years/forms. Once the authorization is filed and recorded with the IRS Centralized Authorization File (CAF), the elected designee will be copied on client notices.

IRS Account Monitoring also requires an individual tax pro to be designated to receive the client's IRS transcripts. The tax pro also needs to have access to the IRS e-Services' Transcript Delivery System (TDS) to download transcripts. To save time, the tax pro should utilize an intermediate service provider (ISP) software to mass download and analyze the transcripts for changes and updates. NATP partners with Tax Help Software, which allows tax pros to download and analyze thousands of transcripts automatically. There are several ISP software providers in the market that will also provide mass download and analysis of IRS transcripts.

The tax pro can use IRS Form 8821, *Tax Information Authorization*, to receive copies of IRS notices as well as obtain access to client IRS transcripts. Form 8821 is effective for seven years after the client's signature date on the form unless revoked by the client or withdrawn by the tax pro.

| Client Profile | Notice and Account Monitoring Benefits |
|---|---|
| Businesses | Full tracking of all transactions and notices, including estimated tax payments, return filing, late filing penalties, balance due issues, etc. |
| Investors | Often do not report all Form 1099-B transactions. Trace unreported income/mismatches to return. You can use wage/income transcripts to identify missing transactions and amend the return if needed. |
| Employers | Track payroll issues such as tax deposits, get alerted on late deposit/payment penalties, confirm return filing, balance due issues. |
| Balance due filer | Alerted on assessed penalties, collection notices and confirmation of payments. If in a payment plan, track payment compliance and any defaulted agreements. |
| Late filer | Assessed penalties, IRS acceptance of late-filed return, enforcement actions. |
| High income/high wealth | Track compliance enforcement issues on this targeted segment, such as audit indicators and other compliance notices. |
| Frequent penalties | Alerted on penalty assessments, evaluate penalty relief qualification with IRS transcripts. |
| Retirees | Track issues related to passive income, such as estimated tax payments made. Also, you can use transcripts to detect identity theft, found often in retiree populations. |
| Extension filers | Confirm extension filed. Also, you can use transcripts to complete late season return with income and payments to avoid notices. |
| Past or current compliance issues | Alerted on enforcement actions. Confirmation that client is meeting agreements and is in good standing, such as payment plan defaults. |
| Moved recently or has job requiring travel | Centralize notice receipt to the tax pro's location to identify issues and respond timely. |
| Fear of IRS anxiety | Clients who request that the tax pro keep them in good standing with the IRS. |

## Who benefits from IRS Notice and Account Monitoring?

The main beneficiary of IRS Notice and Account Monitoring is usually the tax pro. Monitoring allows a tax pro to be "in the know" on their client's IRS issues and information, so they can work proactively to resolve issues and provide needed information to clients. Clients who most benefit from IRS Notice and Account Monitoring have many IRS transactions throughout the year, including businesses or clients with past, present or potential compliance issues. However, Monitoring Services can be beneficial to any client who wants the tax pro to maintain and know if they are in good standing with the IRS.

Some clients who can benefit are included in the above table.

## How to monitor IRS notices and account activity

IRS Notice Monitoring requires use of Form 8821, *Tax Information Authorization*, to get copied on notices. Up to two designees can be copied on notices. The tax firm or an individual tax pro can be designated to receive notices.

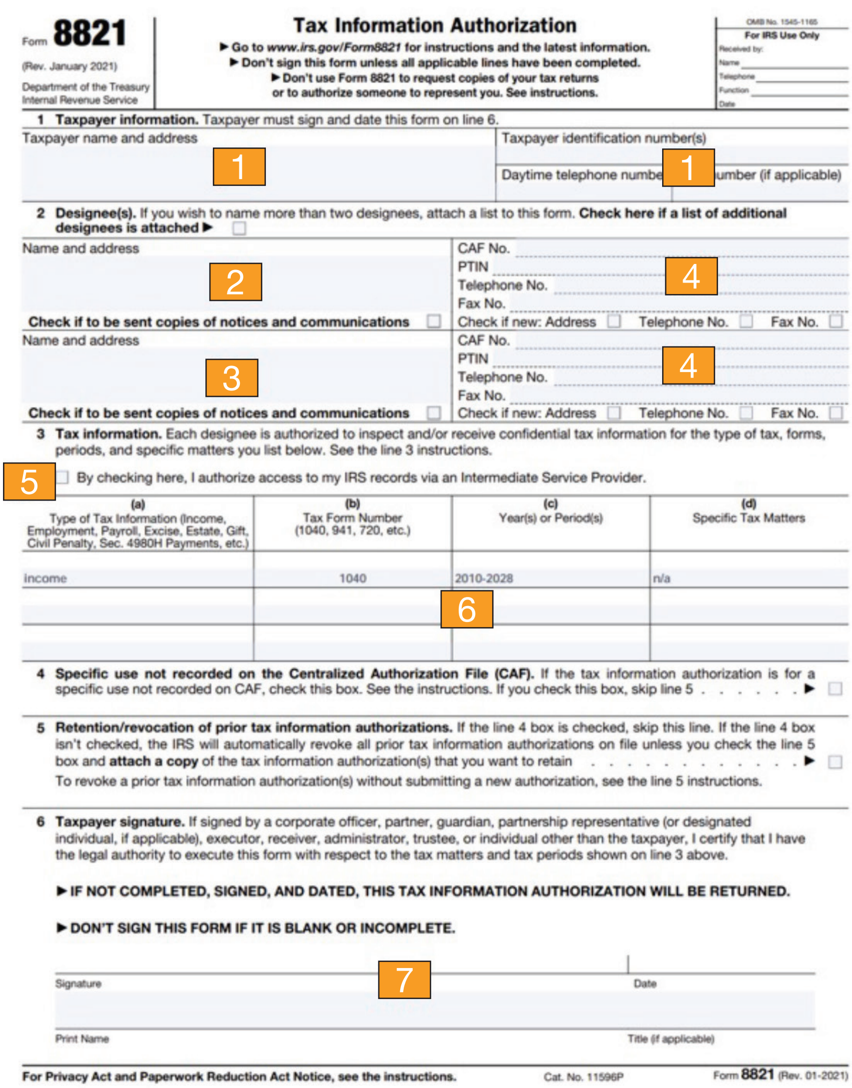
The same Form 8821 can be used for obtaining IRS transcripts to monitor IRS account activity. However, an individual designee must be on Form 8821 to enable downloading of transcripts via the IRS e-Services TDS. To download transcripts from the TDS, the individual designee must also have access to the TDS through an active e-file application. E-file application responsible officials can authorize tax pros to have access to the TDS in their e-file application.

Individual designees should also obtain ISP software to routinely mass download and analyze the authorized clients' transcripts. ISP software providers can provide onboarding instructions to set up client monitoring. When transcripts are downloaded, the ISP can highlight the latest changes to each client's account. The tax pro/designee should routinely download transcripts (recommend weekly) and identify significant actions that warrant further review or action.

If a firm wants to provide both IRS Notice and Account Monitoring, they can complete and have the client sign the Form 8821 (see table and Figure 1 on the next page).

| Form 8821 – Section Completion |
| --- |
| **1. Taxpayer name/TIN:** Exactly as it appears on the return. Phone number is not needed. Important: Joint individual filers will need a separate Form 8821 for the primary and spouse. |
| **2 and 3. Two designees:** First designee (notice monitoring): For notice copies, you can use your “firm,” or an “individual tax pro” if you are a sole practitioner. Select the checkbox to be “copied on notices.” Second designee (IRS account monitoring): If the first designee is not an individual designee, you will need to provide an individual designee in your firm who has access to the IRS e-Services TDS and has ISP software to monitor activity through transcripts. **Note:** You can add more designees by checking the box in Section 2 and attaching the designee and their CAF information on a separate attachment to Form 8821. |
| **4. CAF Information:** Individual designees who do not have a CAF# can obtain one through the Tax Pro Online account. Tax firms can obtain a CAF# when they file their first Form 8821 by writing “none” in the CAF# entry. The IRS will send a CAF# to the firm in 3-4 weeks to use on future Forms 8821. The designee(s) should also enter their contact information and PTIN if applicable. |
| **5. Intermediate service provider (use for IRS account monitoring):** Check the box for ISP software use if you will use any of the ISP software programs to automatically download and analyze transcripts (highly recommended). |
| **6. Forms/years to monitor:** Recommend you go back at least 10 years (more if you have a client with past tax problems) and forward 3 years. For example, for the 2025 tax season for an individual client, you can get a full picture by being authorized for 2010-2028 for the Form 1040. Business taxpayers can add their forms on a business Form 8821. The future years authorized will allow you to forego requesting the Form 8821 for three more years. |
| **7. Signature:** Prefill the client’s name and have them sign and date. Note: The client can e-sign the document, but you must submit all e-signed authorizations through the IRS “Submit 2848/8821” online tool. |

FIGURE 4



Form **8821** (Rev. January 2021) Department of the Treasury Internal Revenue Service

**Tax Information Authorization**

► Go to *www.irs.gov/Form8821* for instructions and the latest information.
► Don't sign this form unless all applicable lines have been completed.
► Don't use Form 8821 to request copies of your tax returns or to authorize someone to represent you. See instructions.

OMB No. 1545-1165
For IRS Use Only
Received by:
Name
Telephone
Function
Date

**1 Taxpayer information.** Taxpayer must sign and date this form on line 6.

Taxpayer name and address

Taxpayer identification number(s)

Daytime telephone number | Plan number (if applicable)

**2 Designee(s).** If you wish to name more than two designees, attach a list to this form. **Check here if a list of additional designees is attached** ►

Name and address | CAF No. | PTIN | Telephone No. | Fax No.

**Check if to be sent copies of notices and communications** | Check if new: Address | Telephone No. | Fax No.

Name and address | CAF No. | PTIN | Telephone No. | Fax No.

**Check if to be sent copies of notices and communications** | Check if new: Address | Telephone No. | Fax No.

**3 Tax information.** Each designee is authorized to inspect and/or receive confidential tax information for the type of tax, forms, periods, and specific matters you list below. See the line 3 instructions.

By checking here, I authorize access to my IRS records via an Intermediate Service Provider.

| (a) Type of Tax Information (Income, Employment, Payroll, Excise, Estate, Gift, Civil Penalty, Sec. 4980H Payments, etc.) | (b) Tax Form Number (1040, 941, 720, etc.) | (c) Year(s) or Period(s) | (d) Specific Tax Matters |
| --- | --- | --- | --- |
| Income | 1040 | 2010-2028 | n/a |
| | | | |
| | | | |

**4 Specific use not recorded on the Centralized Authorization File (CAF).** If the tax information authorization is for a specific use not recorded on CAF, check this box. See the instructions. If you check this box, skip line 5 . . . . . . . ►

**5 Retention/revocation of prior tax information authorizations.** If the line 4 box is checked, skip this line. If the line 4 box isn't checked, the IRS will automatically revoke all prior tax information authorizations on file unless you check the line 5 box and **attach a copy** of the tax information authorization(s) that you want to retain . . . . . . . . . . . . . ►

To revoke a prior tax information authorization(s) without submitting a new authorization, see the line 5 instructions.

**6 Taxpayer signature.** If signed by a corporate officer, partner, guardian, partnership representative (or designated individual, if applicable), executor, receiver, administrator, trustee, or individual other than the taxpayer, I certify that I have the legal authority to execute this form with respect to the tax matters and tax periods shown on line 3 above.

► **IF NOT COMPLETED, SIGNED, AND DATED, THIS TAX INFORMATION AUTHORIZATION WILL BE RETURNED.**

► **DON'T SIGN THIS FORM IF IT IS BLANK OR INCOMPLETE.**

Signature | Date

Print Name | Title (if applicable)

**For Privacy Act and Paperwork Reduction Act Notice, see the instructions.** Cat. No. 11596P Form **8821** (Rev. 01-2021)

With a Form 8821 ready for each client who accepts IRS notice and/or account monitoring, follow these simple steps to monitor their IRS notices and account activity:

| # | Client Profile | Notice and Account Monitoring Benefits |
|---|---|---|
| 1 | *Obtain a Form 8821 for the client* | Complete the forms/years for the type of client (individual, business, etc.) and have the client sign/date the form. |
| 2 | *File the Form 8821 with the IRS CAF* | Ink-signed forms can be mailed, faxed or uploaded to the IRS CAF unit. If the client e-signs, you must upload the e-signed Form 8821 through the IRS's "Submit 2848/8821 Online" tool.<br>The Form 8821 will take between 5-8 days to be recorded with the IRS CAF (varies throughout the year). |
| 3 | *Monitor incoming notices and screen for needed actions* | Historically, about 10% of clients will get an IRS notice (businesses are a little higher). For each notice received, determine if an action is needed. Certain notices have deadlines and urgency for action such as audit and underreporter notices, IRS collection notices, identity theft and math error notices. Some notices are expected, such as adjustment notices from an amended return, and require no action. |
| 4 | *Monitor IRS transcripts for activity and screen for unusual actions* | Using ISP software, weekly download client IRS transcripts (account, return and wage/income) for the years authorized. The ISP software will analyze the transcripts and highlight changes to the client's account. Unusual transactions and enforcement indicators should be investigated. |
| 5 | *Act on notices and discrepancies* | Any notices requiring action or discrepancies in account activity require resolution. You can use the already signed Form 8821 to contact the IRS Practitioner Priority Service (866-860-4259) to obtain more detailed information, if needed. |
| 6 | *Keep your client updated on important activity* | Let your client know of actions on their account, your next steps and their responsibilities, including deadlines, to provide information to you to resolve the issue. Offer additional services, including representation before the IRS, if needed. |

## Next tax season: start IRS notice and/or account monitoring services

You can start IRS Notice and Account Monitoring Service at any time during the year. However, most firms implement monitoring services during tax season when they have peak interaction with each of their clients.

Many tax pros provide this service for an annual fee. Tax pros also offer monitoring services to many business clients they work with throughout the year (i.e., for payroll, bookkeeping, etc.) as a monthly subscription fee. The tax pro can include the monitoring services as part of their current engagement agreement with the client or as a separate agreement with client. The agreement should clearly state the service parameters, which does not include representing the client before the IRS and any other services that would require an additional fee.

IRS Notice and Monitoring Services are a win-win for the client and the tax pro. Clients get the benefit of putting their tax pro in an informed position to help them. Tax pros will have year-round, real-time access to client activity, notices and client IRS transcripts – putting them in a position to proactively resolve any issues and keep them in good standing with the IRS. ▶

# Tax Talk

## Recklessness Leads to Willful Failure to File FBAR Penalty

By J.P. Finet, JD
NATP Tax Content Specialist

An individual can be penalized for willfully failing to file a Report of Foreign Bank and Financial Accounts (FBAR) if they act in reckless disregard of the statute when they don't disclose their foreign accounts, the U.S. Court of Appeals for the 9th Circuit has ruled. As a result, there is no need for the government to prove an individual acted intentionally when not filing an FBAR to impose penalties for willful failure to file.

The decision found the standard for willfulness laid out by the U.S. Supreme Court in its 2007 ruling on Safeco Insurance Co. of America v. Burr, with regard to violations of the *Fair Credit Reporting Act*, also applies to the FBAR statute. In its Safeco decision, the Supreme Court ruled that when a statute bases civil liability on willfulness, it applies not only to knowing violations of the statute, but also to reckless disregard of the statute. Courts have generally interpreted reckless disregard of a rule or regulation as applying in situations where an individual's interpretation of the rules were not objectively reasonable, and further research would have shown their interpretation to be incorrect.

### Failure to report New Zealand accounts

Timberly Hughes owned a New Zealand limited liability company (LLC) that has operated a winery in that country since 2001. She formed another LLC in 2013 to operate a wine bar, also located in New Zealand. Hughes was the sole owner of both companies and had a financial interest in, and signature authority over, the two companies' accounts at the ANZ Bank New Zealand, Ltd.

Hughes did not file FBARs for years 2010 through 2013. The U.S. government found her failure to file was "willful" and assessed $678,899 in penalties against her. When she did not pay, the government filed a federal court lawsuit to collect the amount due, prejudgment interest and late payment penalties.

A trial was held in the U.S. District Court for the Northern District of California in October of 2021, and that court found Hughes's failure to file in 2012 and 2013 to be "willful" for the purposes of applying the FBAR statute. The district court concluded that, for civil FBAR penalties, willfulness can be shown through recklessness or willful blindness. It found that for 2012 and 2013, Hughes plainly saw "at least the basic instructions" that she was required to file an FBAR because she checked the box on her 2012 returns to indicate that she was required to file one. However, she did not file an FBAR for 2012 and answered the same question inaccurately for 2013.

The district court found Hughes did not act willfully in not filing FBARs for 2010 and 2011 because there was no evidence she was aware of the filing requirement or that she received information that would put her on notice of the requirement.

### Recklessness enough to find willfulness

On appeal, Hughes contended that the district court erred because it should have been required to find that she subjectively intended to not file her FBARs for 2012 and 2013. By making that request, she was asking the 9th Circuit to break with the precedent set by other appeals courts, which found that the Supreme Court's reasoning in Safeco applies to the FBAR statute.

Hughes argued that the FBAR statute was "inherently punitive;" therefore, applying the objective recklessness standard would punish actors who were merely negligent. Because of the statute's punitive nature, she contended that nearly every FBAR violation could be found to have been willful, which would render the portions of the FBAR statute that refer to non-willful violations superfluous.

The 9th Circuit explained that Hughes provided no evidence that the other courts that addressed the issue have conflated negligence with recklessness. It added that the other courts have expressly stated that civil recklessness requires proof of more than mere negligence and it appears the district court did not do so. The 9th Circuit noted that the district court specifically found she was required to file an FBAR, and her explanations for failing to do so were inconsistent and not credible. ▶

*U.S. v. Hughes, Nos. 23-15712, 23-15713 (9th Cir. 2024)*

# Donating Appreciated Stock

By Virginia Hilton, CPA, MST
NATP Tax Content Specialist

**Q:** Hilaire inherited stock with a low cost basis from her deceased relatives' portfolios. She wants to gift stock to her church's capital campaign worth $20,000 per year for three years. She makes cash donations of $4,000 to other charities and has adjusted gross income (AGI) of $100,000. How will her tax preparer determine the limits of Hilaire's 2024 gifts, given the gifting limits tied to AGI?

**A.** Hilaire's tax preparer needs to know three things:

1. The type of the charitable organization receiving the donation (a church)
2. Hilaire's AGI
3. Hilaire's ***cash*** charitable donations to date

## Type of organization

The IRS's Tax Exempt Organization Search (TEOS) tool categorizes a qualified organization as either a 50% charity, 30% charity or other organization. Churches are considered 50% charities, meaning, gifts to these charities are considered first in computing the overall 50% limit.

Six different percentages of AGI limitations apply to charitable contributions, not all of which apply to Hilaire.

## The 60% limitation

Applies to her cash gifts to 50% charities. Considering her AGI, her deductible limit on gifts would be $60,000 ($100,000 x .60) and the entire $4,000 is deductible from this category.

The $4,000 contribution will be taken into account for the next limitation, called the 50% overall limitation for other contributions. This limits overall total contributions to 50% of AGI. If her "overall limit" is $50,000 ($100,000 x .50), it is now reduced to $46,000 by the $4,000 cash to the 50% charities.

The next 50% limitation does not apply to Hilaire.

## The 30% limitations

Hilaire is subject to the "special limitation" as it applies to gifts of appreciated long-term gain property [(§170(b)(1)(C)(iv)] to a 50% charity, her church.

Normally, a contribution of capital gain property is measured by its FMV on the date of the gift. Hilaire's appreciated stock gift, therefore, can only be the lesser of 30% of AGI, ($30,000) or 50% of AGI reduced by all gifts made to a 50% charity.

For the overall limit, the contribution base was reduced to $46,000 after her cash gifts. $30,000 remains to be donated from the 30% category, so the amount of $20,000 could be gifted in 2024 from additional appreciated stock.

In sum, Hilaire's 2024 gifts:

- $4,000 cash to 50% charities
- $20,000 stock to her church for the annual campaign

Total overall gifts: $24,000, which is below the "overall limit" of 50% of AGI. Therefore she can deduct the full amount of contributions she wants to make in 2024. ▸

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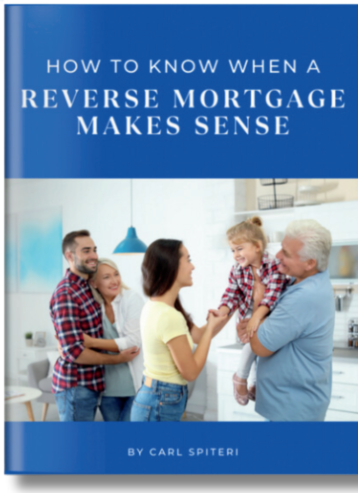


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2. **If for any reason you change your mind**, your old website is unchanged and you can cancel your service within 30 days for a full refund and your existing provider won't even know you thought about leaving.
3. **Once you confirm you prefer your new website,** GetNetSet will make it so when people go to your domain name (e.g. yourdomain.com) they see your new website. Then you can cancel services with your old website provider.

A lot of clients are unhappy with their current website provider and switch to GetNetSet saying things like:

**"I had a website with another provider that was stale and they didn't do much but my costs kept going up. I'm not even sure anyone used the website. I'm not a website/ marketing expert and I need someone who can handle this for me and get us listed on search engines. I'm also interested in the other features that GetNetSet offers."**

If this sounds like you, know that GetNetSet has helped many NATP members who have said the same thing.

Partner NATP™

30 DAYS MONEY BACK GUARANTEE

**Reserve your savings!** 877-207-4646 getnetset.com/NATP564